

Morgan Lewis

STARTUP & ACCELERATE

**Know Your Next Steps - Later
Stage/Preferred Stock Financing**

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Current Market Environment

Key Takeaways

- GLOBAL:
 - Higher interest rates around the world have led to negative returns across equities, credit, rates, and commodities.
 - High-yield credit spreads are now above 500 basis points.
- UNITED STATES:
 - Mixed economic signals:
 - Falling real GDP.
 - Rising interest rates, perceived lack of access to capital.
 - Consumer Price Index up at 8.3% for August year-over-year.
 - “Down Rounds” will not destroy companies, despite current market conditions.
 - Investors are still investing money into startups, despite the market conditions.

The Myth of “Valuation”

- In the early stage world – “valuation” is often described as a fixed number – for example “the company raised financing at a \$100m valuation.” Or “Andressen’s investment valued the company at \$1b.”
- “Enterprise Value” vs. “Equity Value”
- Pre-Money
- Post-Money
- Price Per Share
- “Down Rounds”
- Valuation at “Exit”

Anti-Dilution “Protection”

- Price-Based Anti-Dilution Protection and what equity issuances are included in each form:
 - Narrow-Based Weighted Average: $\text{New conversion price} = \text{old conversion price} * (\text{current common-equivalents outstanding of a particular class} + (\text{the consideration received in the current round} / \text{original purchase price})) / (\text{common-equivalents outstanding of a particular class} + \text{common-equivalents issued in current round})$
 - Broad-Based Weighted Average: $\text{New conversion price} = \text{old conversion price} * (\text{current common-equivalents outstanding of all classes of equity} + (\text{the consideration received in the current round} / \text{original purchase price})) / (\text{common-equivalents outstanding} + \text{common-equivalents issued in current round})$
 - Full-Ratchet: $\text{New conversion price} = \text{conversion price of later-issued equity in a 'down-round'}$
 - $\text{New Conversion Price} = (\text{initial preferred equity price per share}) * (\text{all shares of all outstanding equity} + \text{aggregate consideration received by the company with respect to the new issue} / \text{new conversion price}) / (\text{total shares of all outstanding equity} + \text{number of shares of stock issued in the subject transaction})$
- Preemptive Rights and Participation in Future Equity Issuances/Raises
- Governance and Veto Rights
- Pay to Play

Elements of a Capitalization Table

- Startups must have a solid understanding of their capitalization table.
 - Know where you are.
 - Know where you are headed.
 - Consider the following:
 - Authorized equity pool (issued and subject to vesting v. dry powder).
 - Securities converting into equity.
 - Future funding needs.
 - Operational plans.

Preference/Priority

- Secured Debt
 - Debt backed by collateral.
 - Lender holds a lien on the collateral.
- Subordinate Debt
 - Debt that will not be repaid until another debtholder (or group of debtholders) has been repaid.
- “Venture Debt”
 - Specifically designed for early-stage, high-growth companies with venture capital backing.
 - Principal loan amount often based on the early-stage company’s balance sheet.
- Senior Preferred
 - In the event of a company’s liquidation, the “Senior Preferred” stockholders receive liquidation distributions first, before any other type of stockholder.

Preference/Priority

- **Pari Passu Preferred**
 - In the event of a company's liquidation, the "Pari Passu" stockholders receive liquidation distributions at the same time.
- **Junior Preferred**
 - In the event of a company's liquidation, the "Junior Preferred" stockholders receive liquidation distributions after the Senior Preferred stockholders.
- **Common Stock**
 - The company's basic share of stock.
 - Entitles holder to voting rights.
- **Junior Common Stock**
 - In the event of a company's liquidation, the "Junior Common" stockholders receive liquidation distributions after the regular Common Stock holders.

Other Terms

- Governance
 - The system of rules, practices, and processes that govern a company.
 - Charters, Bylaws, Unanimous Written Consents of the Board of Directors.
 - Formation Certificates, Operating Agreements, Unanimous Written Consents of the Board of Managers (or Members).
- Path to Liquidity
- Drag-Along
 - If a majority shareholder sells their stake in the company, the prospective owner can force the remaining minority shareholders to join the deal.
- Tag-Along
 - If a majority shareholder sells their stake in the company, minority shareholders can join that sale.

Other Terms

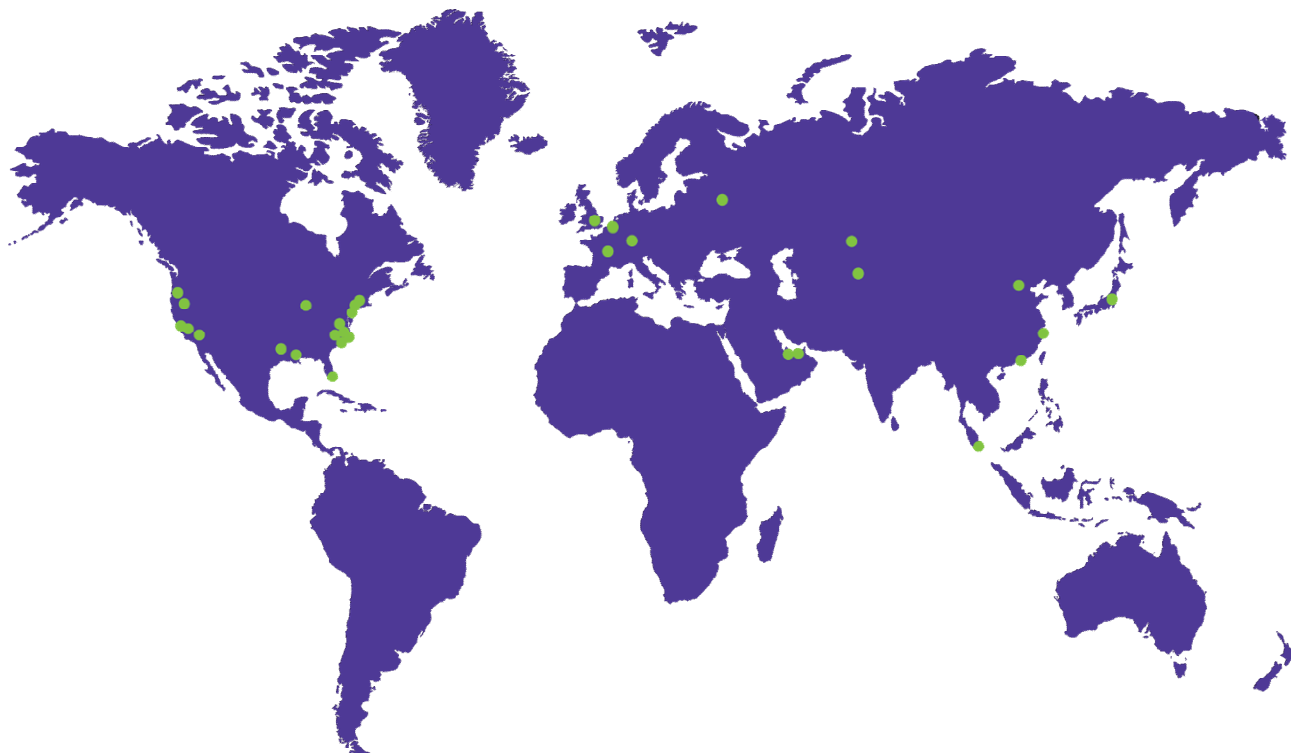
- Redemption Rights
 - Allows investors to require a company to repurchase their shares after a specified period of time.
- Registration Rights
 - Entitles an investor who holds restricted stock to require that a company register the shares publicly so that the investor holds freely-transferable shares.
- General Solicitation and Other Securities Concerns
 - A solicitation that conditions the market for a company's securities offering.
 - Advertisements, Television and Radio Broadcasts.
 - Websites, Social Media, and Interviews.
 - Communications by or on behalf of the company.
 - Most common exemptions under Rule 506 of Regulation D
 - 506(b) – Unlimited number of "accredited investors" and up to 35 non-accredited investors.
 - 506(c) – General solicitations so long as investors are all accredited and the company takes reasonable steps to verify accredited status.

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North America

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