

The Mechanics of Capitalizing Your Venture

Formation, Financing & the Cap Table

BIO Entrepreneurship Boot Camp 2022

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regulatory filings (federal and state)

licensing agreements

stock purchase documents; stockholders agreements

**employment/consulting agreements;
stock option plans**

articles of incorporation; by-laws

Memory What did we agree to?

Governance Who gets to decide what

Exit Who gets what (and in what order)

Disputes See “Memory” above

Formation

why?



**Value Proposition
for Investors**

how good is the story

Entity structure, equity distribution, employee compensation are understandable, appropriate and consistent with typical arrangements

Risks associated with technology development and product acceptance have been identified, and strategies for minimizing them are sensible

Estimates of market size, timeline to market entry; pace of acceptance (and scale of reimbursement) are credible

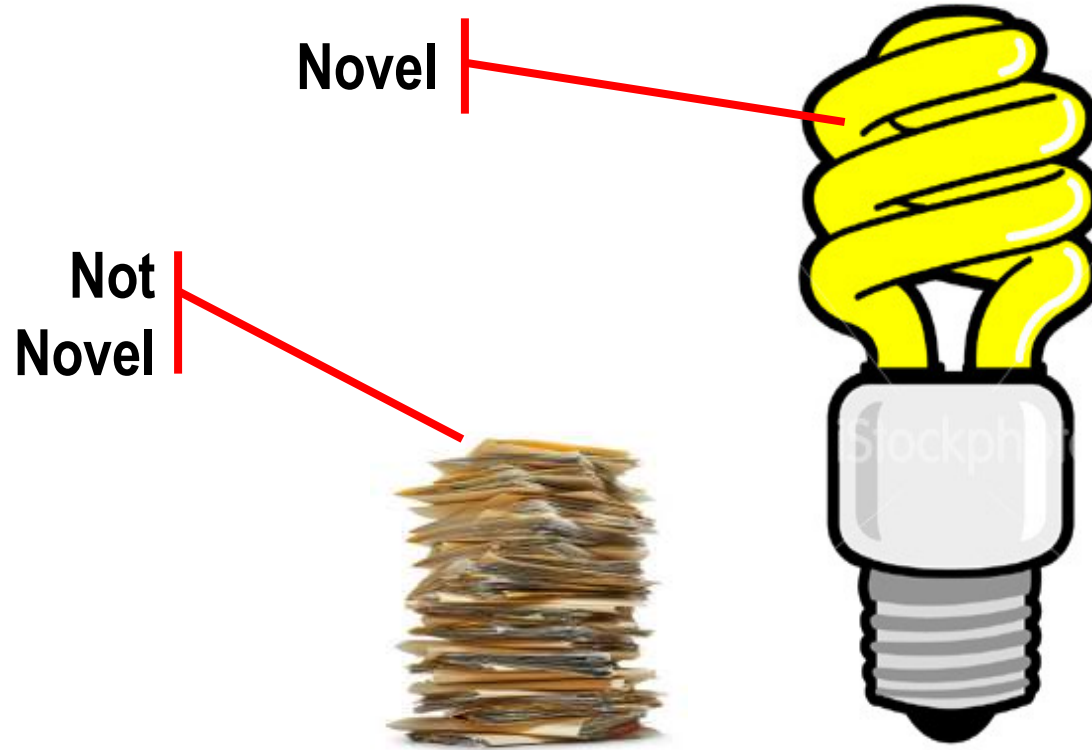
how good is the story

Entity structure, equity distribution, financing terms, employee compensation are understandable, appropriate and consistent with typical arrangements

Risks associated with technology development and product acceptance have been identified, and strategies for minimizing them are sensible

Estimates of market size, timeline to market entry; pace of acceptance (and scale of reimbursement) are credible

The Value Proposition – what matters



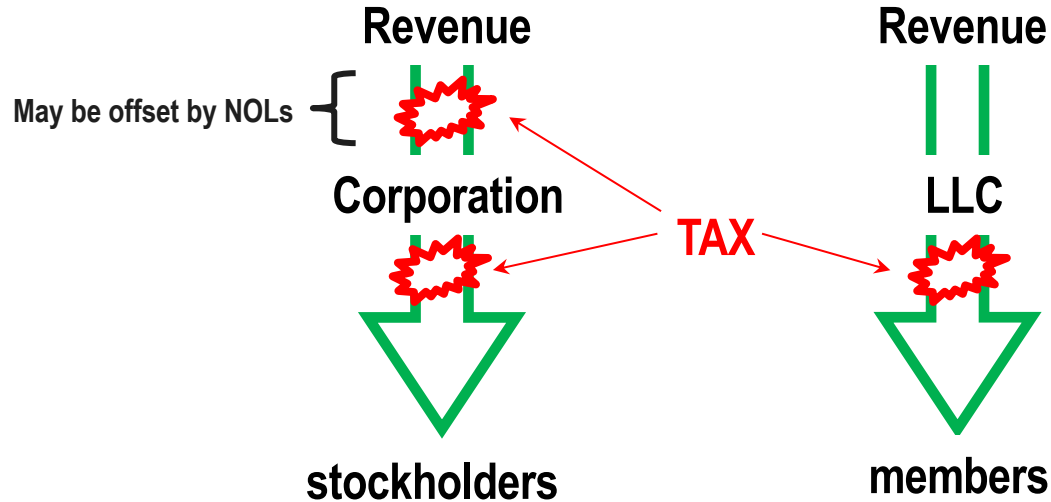
Formation

why?
what?

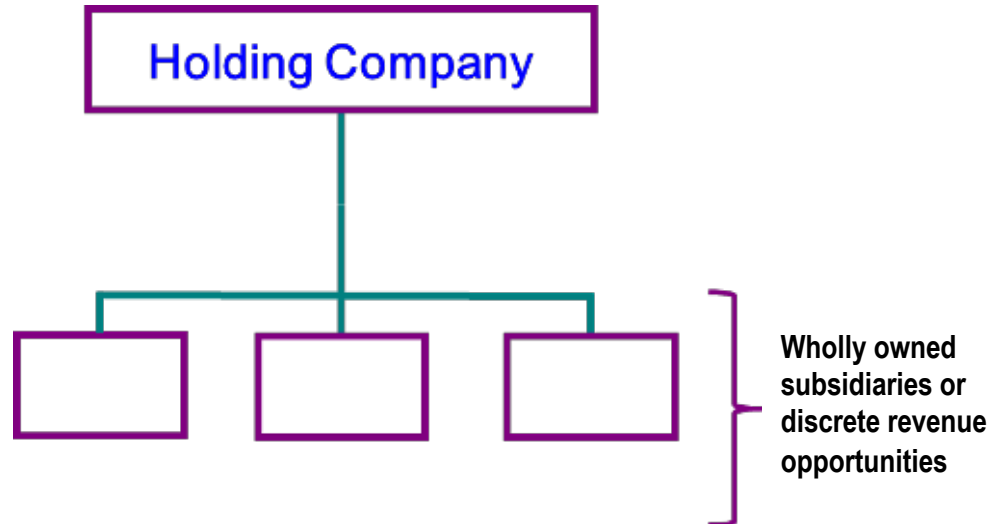
“C” Corporation	the default choice; well-understood capital & operational structure; M&A/IPO advantages
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Limited Liability Company (LLC)	tax advantages (esp. for partial exits); simplified operational structure (ex. members as employees)
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Also, where to incorporate/organize?



but, cap. gains tax “forgiveness” for “C” corp. stock sale (IRC§1202)



also, consider IRS perspective on employees as members

Governance (and the Board – CEO relationship)

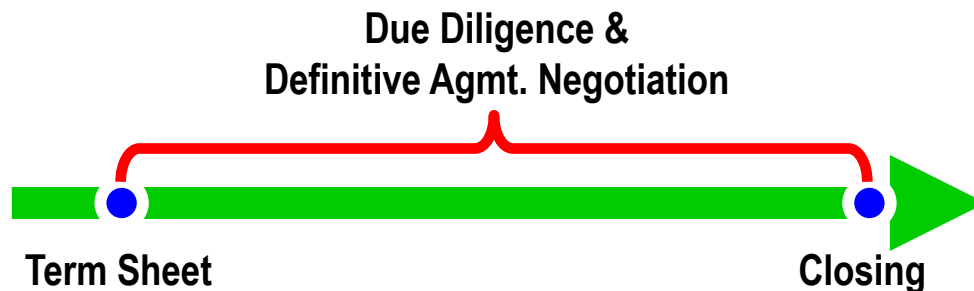


Influenced by: timely communication (esp. bad news; adherence to Board policies)

The Early Life of the Company

Stage	Goals
Launch	<i>establish governing structure; allocate ownership interests (establish control over IP)</i>
Financing	<i>Money (could also establish key relationships in financing & tech. development)</i>
R&D (&C)	<i>enable/accelerate technology development, market entry</i>

Financing (Process & Documentation)



Document	Purpose
Term Sheet	<i>Preliminary terms of investment: pre-investment valuation; class & rights of stock to be sold; issue price; board representation; closing conditions (due diligence; aggregate investment commitment)</i>
Purchase Agreement, etc.	<i>Definitive investment terms; ancillary agreements; company reps & warranties; pre- & post-closing conditions</i>

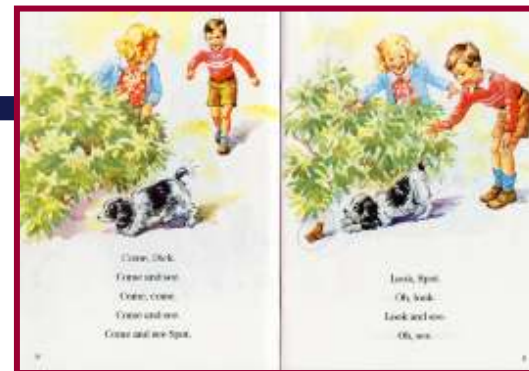
Financing (Documentation – equity round)

Document*	Purpose
Stockholders Agreement	Rights/Obligations applicable to all Stockholders <i>(i.e., restrictions on transfer of shares; designation of board nominees & election of directors, etc.)</i>
Investor Rights Agreement	Rights/Obligations applicable to Investors <i>(i.e., preemptive purchase rights, protective provisions, registration rights, etc.)</i>
<i>Right of First Refusal & Co-Sale Agreement</i>	<i>allow Company and then stockholders to purchase selling stockholders' shares; require stockholders to sell shares along with selling stockholders</i>
<i>Voting Agreement</i>	<i>require stockholders to vote on certain matters (esp. election of directors, but can require votes on other matters)</i>

*see NVCA model Series A transaction documents (www.nvca.org)

Financing (Key Investment Terms – Preferred Stock)

Term	Function	Purpose
Liquidation Preference	Return of initial investment (+ dividends) ahead of general distribution to stockholders	Downside protection (if just 1X) Upside benefit (if > 1X)
Anti-Dilution	Downward adjustment of initial issue price if future round priced lower	Downside protection against over-valuation of the company for the initial investment
Voting Rights	Board representation Protective provisions	Ability to influence (maybe control) future key decisions about the business & exit



Keep it simple
Keep it accurate

The Rules:

SEC (“1933 Act”) – exemption from registration
but consider state “Blue Sky” requirements – prior registration?

Investor Disclosures – material facts; no material omissions

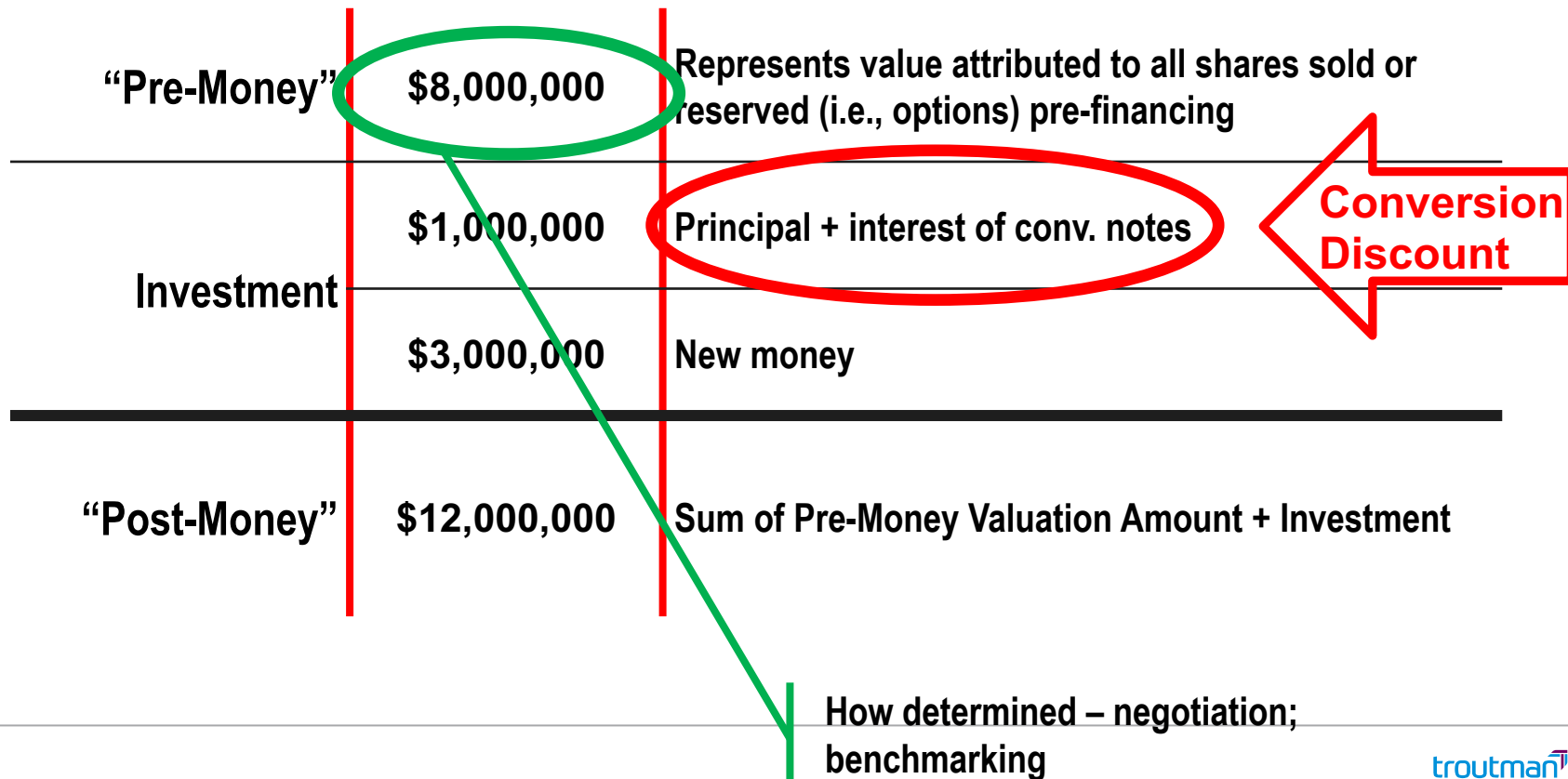
“Accredited” Investors – having ability to withstand loss and evaluate risk

private-private vs. public-private offerings (Rule 506(b) vs. 506(c)*)

***(e.g., www.verifyinvestor.com)**

What	Why
Valuation	<i>Establishes relative equity interest acquired by new investors (may trigger anti-dilution rights of older investors – a “down round”)</i>
Capitalization	<i>Establishes relative voting rights and liquidation preferences of all stockholders</i>

Financing (“Pre-Money” & “Post-Money”)



Financing (variables)

“Pre-Money”	\$8,000,000
Note Conversion Discount	30%
Investor Requirements	<i>“Post Money” Cap? (say, \$10M)</i>

Financing (Valuation – “founder friendly” method)

Founders & Option Pool	1,000,000	64.37%
Note Holders	178,571	11.49%
New Investors	375,000	24.14%
Total Issued & Reserved Shares	1,553,571	100%

Series A issue price	$\$8.00$ ($\$8\text{M Pre-Money} \div$ (Founder & Option Pool Shares))
Eff. “Pre-Money” Valuation	$\$8,000,000$
Eff. “Post-Money Valuation	$\approx \$12.43$ million (Total Shares \times Series A issue price)

Financing (Valuation – “investor friendly” method)

Founders & Option Pool	1,000,000	55.71%
Note Holders	256,407	14.29%
New Investors	538,455	30.00%
Total Issued & Reserved Shares	1,794,862	100%

Series A issue price	\$5.5715 (to meet investor-req. \$10M post-money val.)
Eff. “Pre-Money” Valuation	\$5,571,500
Eff. “Post-Money Valuation	≈ \$10 million (Total Shares × Series A issue price)

Financing (Valuation – “dollars invested” compromise method)

Founders & Option Pool	1,000,000	63.1%	} Reflects new investment as % of post-money
Note Holders	188,677	11.9%	
New Investors	396,223	25%	
Total Issued & Reserved Shares	1,584,900	100%	

Series A issue price	\$7.5715 (to reflect pre-money + aggregate investment)
Eff. “Pre-Money” Valuation	\$7,571,500
Eff. “Post-Money Valuation	≈ \$12 million (Total Shares × Series A issue price)

Preferred Stock -- The “Participation” Reward



“Participating” Preferred Stock Payout = Liquidation Preference Amount + pro rata portion (calculated with common stock on conversion of all preferred stock to common) of Exit proceeds remaining after all junior Preferences paid

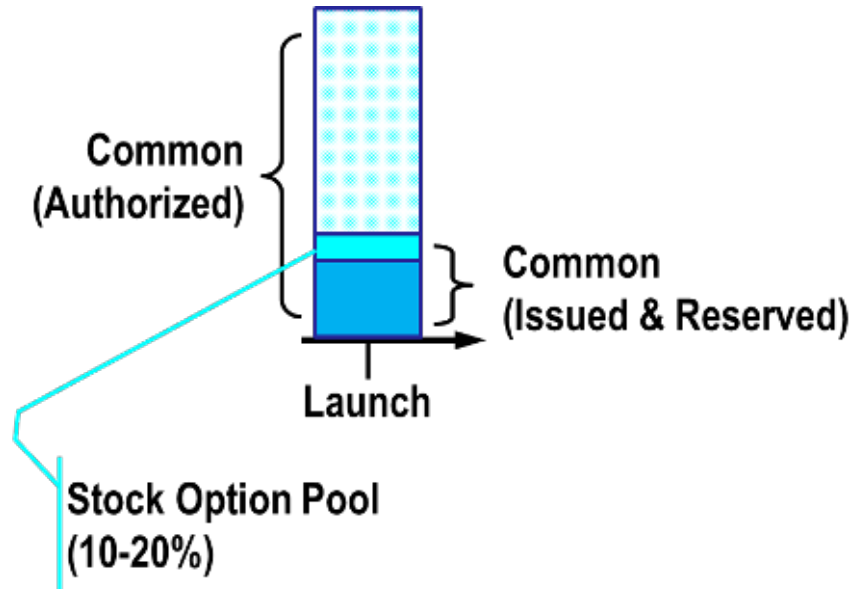
Participation “Cap” – preferred holder entitled to either (i) the cap amount (i.e., 2X liq. pref.), or (ii) the amount payable if the preferred stock was non-participating (i.e., participates in the total proceeds with common stock on an as-converted to common stock basis

Participation Cap “Indifference” – Series C Distribution

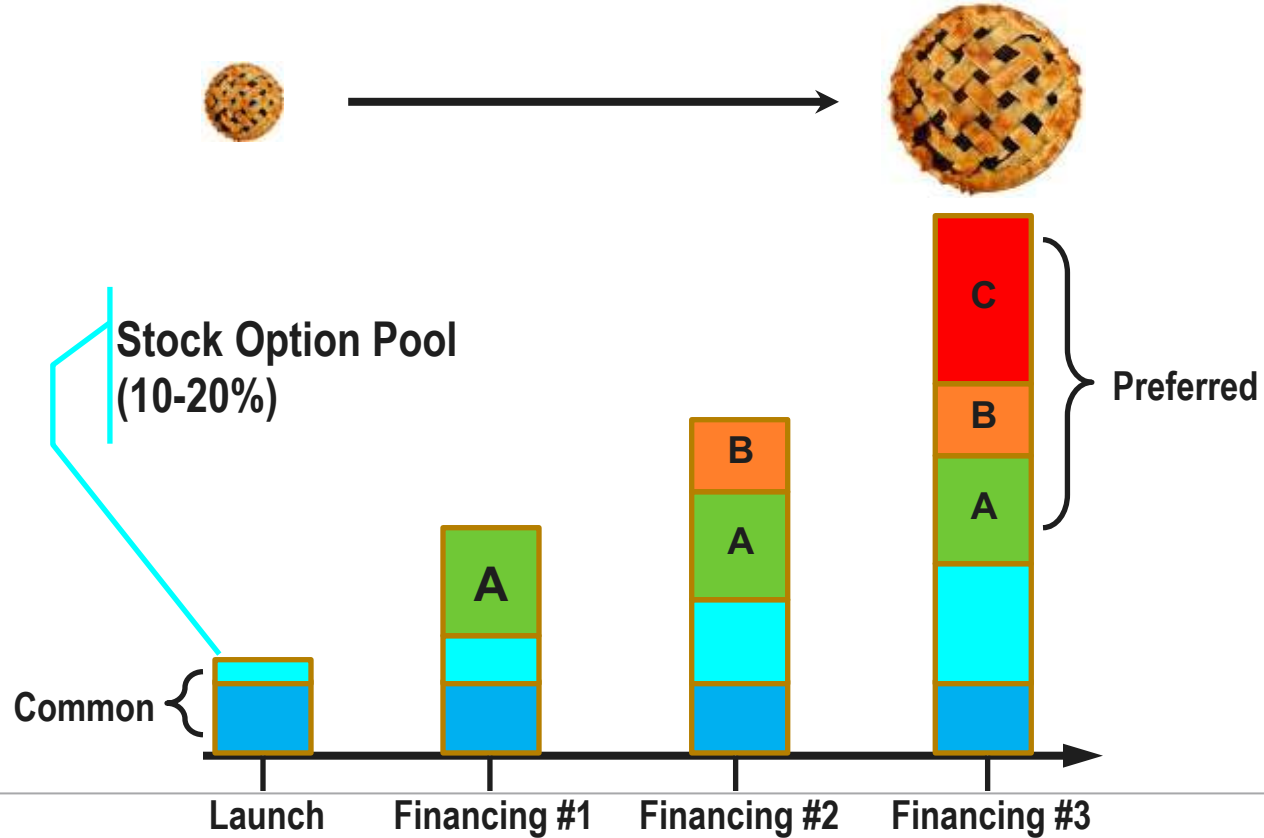
	% of Issued Shares (as converted to Common)	Total Distribution	Liquidation Preference	2X Cap Distribution
\$60M Exit	45%	\$27,000,000	\$10,000,000	\$20,000,000
\$40M Exit		\$18,000,000		\$20,000,000

Participation Cap can leave more for Common Holders at higher Exit and leave less for Common Holders at lower Exit; also, disincentive for Preferred Holders with Cap to seek higher Exit until Exit return greater than Cap payout

Financing (Capitalization)



Financing (Building the Cap Table)

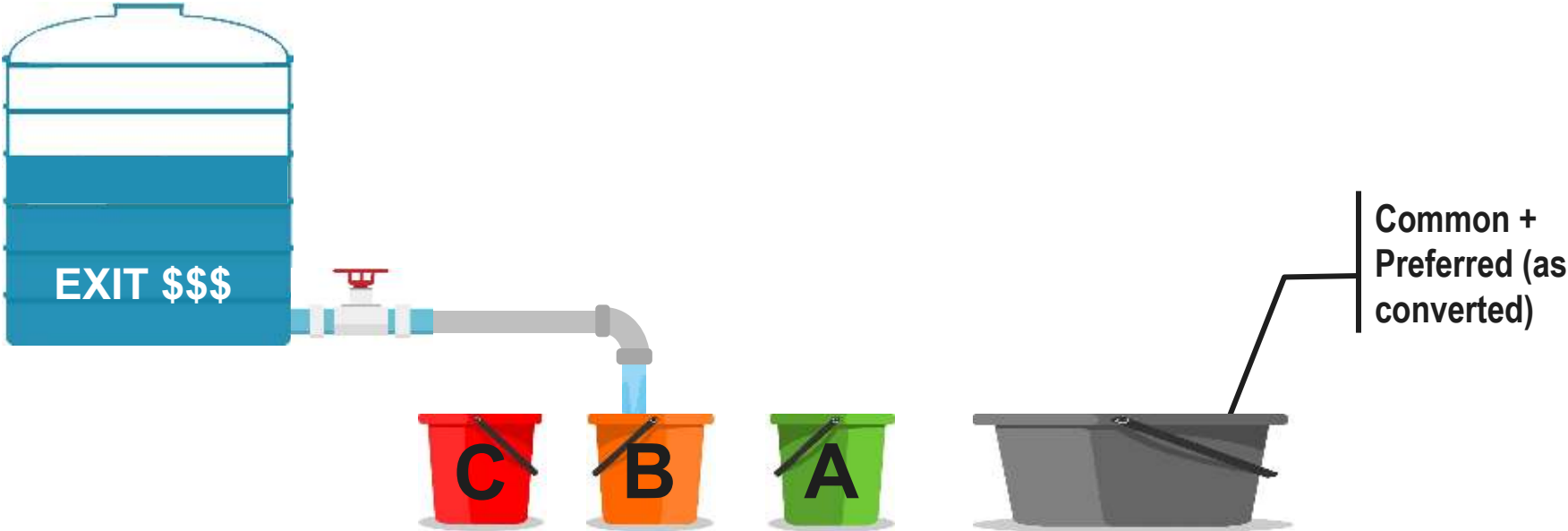


EXIT (payout “waterfall”)



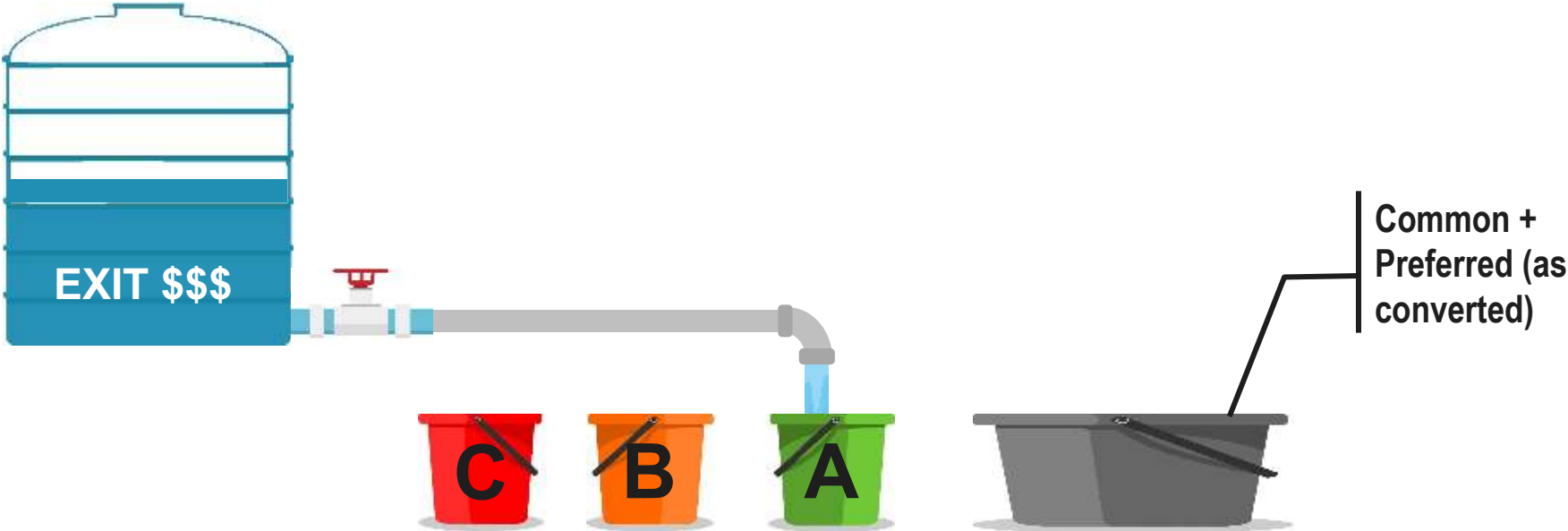
Liquidation Preference Distribution

EXIT (payout “waterfall”)



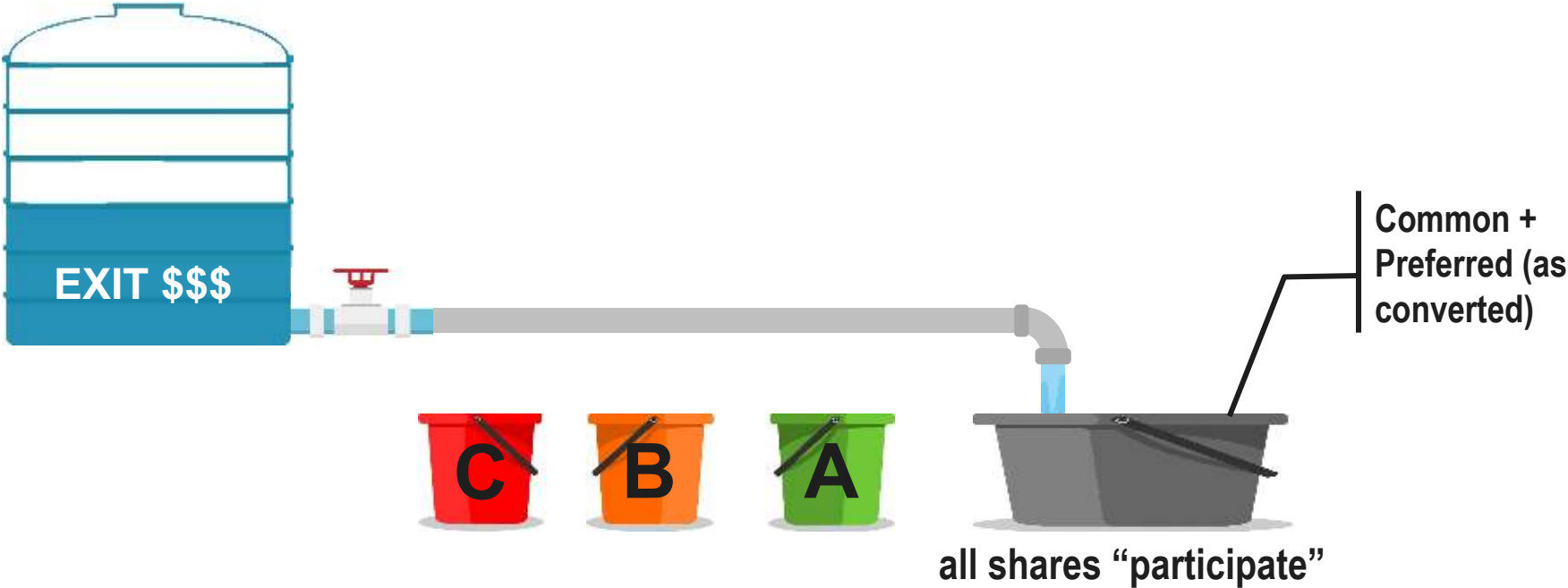
Liquidation Preference Distribution

EXIT (payout “waterfall”)



Liquidation Preference Distribution

EXIT (payout “waterfall”)



Liquidation Waterfall -- \$150M Exit, Participating Preferred

Exit Proceeds	\$150,000,000	Amount remaining after payment of outstanding debt, etc.
	-\$15,000,000	Series C
Liquidation Preference Payouts	-\$10,000,000	Series B
	-\$5,000,000	Series A
Net Exit Proceeds	\$120,000,000	Amount to be distributed to Common + Participating Preferred on pro rata basis

Liquidation Waterfall -- \$150M Exit, Participating Preferred

	% of Issued Shares (as converted to Common)	Liquidation Preference	Distribution of \$120M Net Exit Proceeds	Total Distribution (~% of Exit)*	ROI
Series C	35%	\$15,000,000	\$42,000,000	\$57,000,000 (38%)	3.8X
Series B	25%	\$10,000,000	\$30,000,000	\$40,000,000 (26.7%)	4X
Series A	10%	\$5,000,000	\$12,000,000	\$17,000,000 (11.3%)	3.4X
Common	30%	N/A	\$36,000,000	\$36,000,000 (24%)	??X

all Exits should
end like this . . .



Financing (Therapeutic Valuation Metrics)*

Seed Round - in millions			1st Round - in millions			2nd Round - in millions		
Pre-Money	Capital Raise	Post-Money	Pre-Money	Capital Raise	Post-Money	Pre-Money	Capital Raise	Post-Money
6.5 +/- 2.3	0.9 +/- 0.8	7.4 +/- 3.1	9.6 +/- 7	6.9 +/- 7.7	16.5 +/- 14.7	35.7	13.2 +/- 13.9	48.9 +/- 13.9
----- ~15 months -----			----- ~19 months -----			----- ~17 months -----		
<ul style="list-style-type: none"> • Proof of concept with IND candidates • Selection of clinically relevant animal model(s) 			<ul style="list-style-type: none"> • Rodent and non-rodent tox data • Selection of IND enabling compound 			<ul style="list-style-type: none"> • Human safety (Phase I) • 		
3rd Round - in millions			4th Round - in millions			Exit Details		
Pre-Money	Capital Raise	Post-Money	Pre-Money	Capital Raise	Post-Money	Capital Raise	Exit Value	Months
50.0	17.3 +/- 17	67.3 +/- 17	148.3	29.8	178.1	~70	~226.7	~60-84 months
----- ~13 months -----								
<ul style="list-style-type: none"> • Efficacy studies in patients • Patient dose range studies (Phase IIb) 			<ul style="list-style-type: none"> • Phase III • 					

*data compiled by and made available through Pittsburgh Life Sciences Greenhouse

Financing (Therapeutic Valuation Metrics)

Seed Round - in millions		
Pre-Money	Capital Raise	Post-Money
6.5 +/- 2.3	0.9 +/- 0.8	7.4 +/- 3.1
----- ~15 months -----		
<ul style="list-style-type: none"> • Proof of concept with IND candidates • Selection of clinically relevant animal model(s) 		

1st Round - in millions		
Pre-Money	Capital Raise	Post-Money
9.6 +/- 7	6.9 +/- 7.7	16.5 +/- 14.7
----- ~19 months -----		
<ul style="list-style-type: none"> • Rodent and non-rodent tox data • Selection of IND enabling compound 		

Exit Details		
Capital Raise	Exit Value	Months
~70	~226.7	~60-84 months

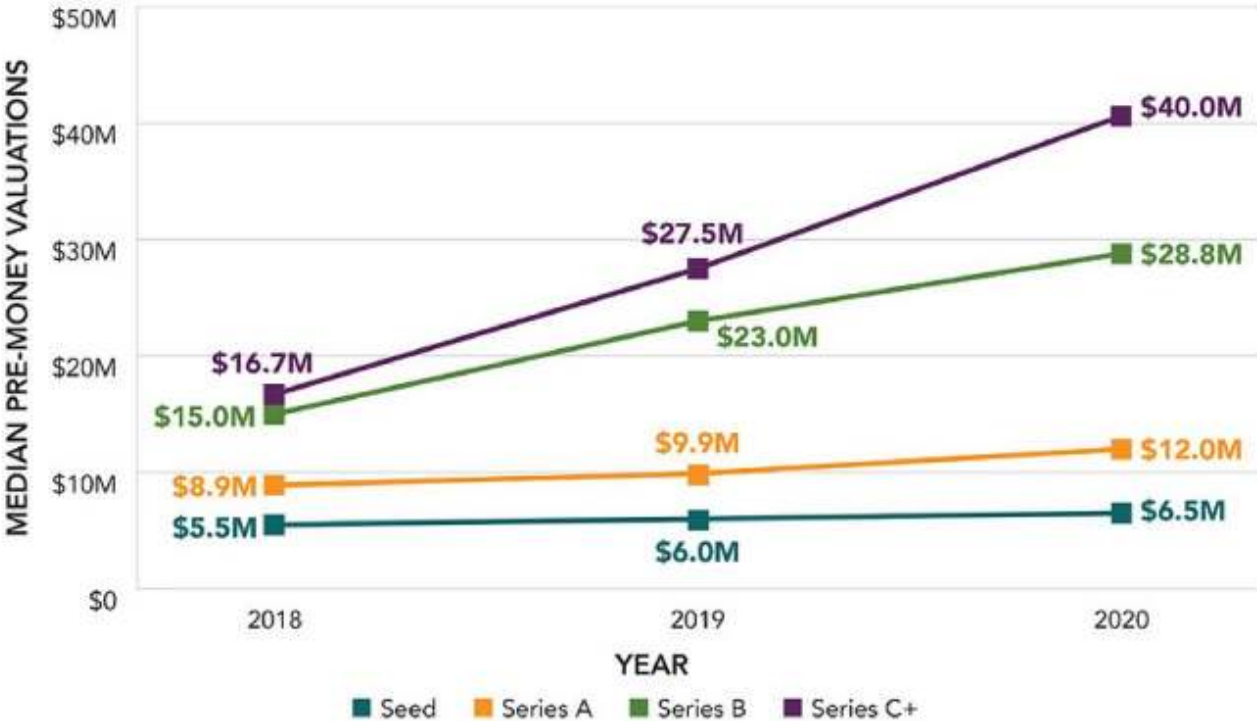


Figure 11 – Valuations are rising, especially in later stages

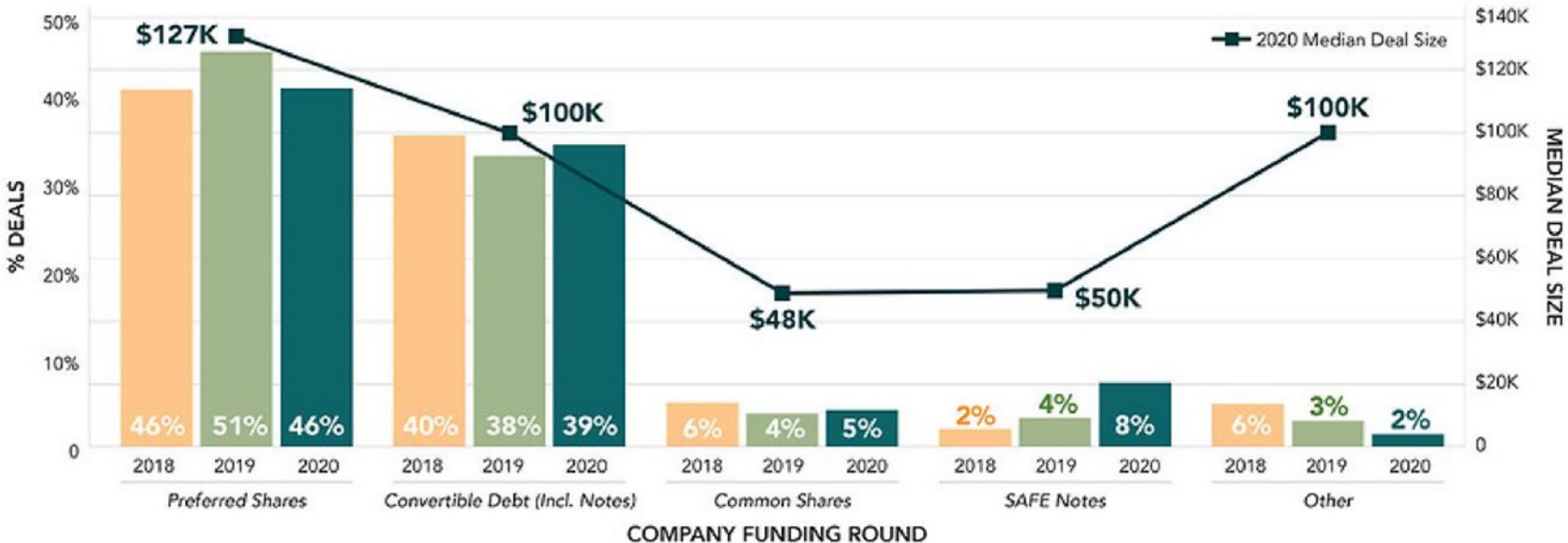


Figure 15 – Preferred Equity & Convertible Debt Dominate Angel Deals



Figure 16 – C Corp Dominate Company Structures

Certificate of Incorporation – Stock Classes

ARTICLE VI

A. CLASSES OF STOCK; RANK.

1. Designation of Series. The aggregate number of shares of stock that the Corporation shall have the authority to issue shall be 63,000,000 shares, consisting of (a) 35,000,000 shares of Common Stock, \$0.001 par value per share (“Common Stock”), and (b) 28,000,000 shares of Preferred Stock, par value \$0.001 per share, 13,000,000 shares of which shall be designated Series A Convertible Participating Preferred Stock (the “Series A Preferred Stock”), 5,000,000 shares of which shall be designated Series B Convertible Participating Preferred Stock (the “Series B Preferred Stock”) and 10,000,000 shares of which shall be designated Series C Convertible Participating Preferred Stock (the “Series C Preferred Stock”). The original issuance price of the Series A Preferred Stock shall be \$1.04 per share (the “Original Series A Issue Price”), the original issuance price of the Series B Preferred Stock shall be \$1.126 per share (the “Original Series B Issue Price”), and the original issuance price of the Series C Preferred Stock shall be \$1.5055 per share (the “Original Series C Issue Price”). The Series A Preferred Stock, the Series B Preferred Stock and the Series C Preferred Stock are referred to collectively as the “Preferred Stock”.

Authorized Shares
(all classes)

Authorized
Common

Authorized
Preferred

Type of
Preferred

Certificate of Incorporation – Liquidation

2. Liquidation.

(a) Series C Liquidation Amount. In the event of any liquidation, dissolution or winding up of the Corporation (each such event a “Liquidation Event”), either voluntary or involuntary, the holders of Series C Preferred Stock shall be entitled to receive, prior and in preference to any distribution of any of the assets of the Corporation to the holders of Junior Shares, by reason of their ownership thereof, an amount per share equal to the sum of (i) One Hundred Percent (100%) of the Original Series C Issue Price (as adjusted for any stock splits, stock dividends, reverse stock splits, stock combinations and other similar capitalization changes) (such sum, the “Series C Liquidation Amount”). If upon the occurrence of a Liquidation Event, the assets and funds legally available for distribution to stockholders shall be insufficient to permit the payment to all holders of Series C Preferred Stock of the full Series C Liquidation Amount, then the entire assets and funds of the Corporation legally available for distribution to stockholders shall be distributed ratably among the holders of Series C Preferred Stock based on the preferential amounts each such holder is otherwise entitled to receive.

**“Liquidation Event”
Includes M&A exits**

**Liquidation
Preference Amount**

**Seniority in
Liquidation**