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Angel On Board: Challenges Of Early-Stage Funding

Law360, New York (September 08, 2009) -- It has become a cliché that capitalism is a process of "creative destruction," a phrase first coined by the economist Joseph Schumpeter.

While the economic carnage of the current recession clearly demonstrates the "destructive" part of this phrase, turmoil such as this frequently fosters entrepreneurial "creativity," giving rise to new business ideas and models. But new ideas can only become real businesses if the entrepreneur can get financing.

For example, suppose an entrepreneur wishes to develop a prototype for a new Web-based screening method for identifying children with certain congenital genetic conditions.

She has statistics for the estimated patient populations of the various conditions and some marketing data showing how likely the demand would be to use the service at various price points.

Now, she wants to raise $1 million to test a prototype for her service. How much of her company does she have to offer to potential investors in order to raise the money? The answer is a direct function of what the investors think her company is worth.

While some entrepreneurs may be able to find early-stage ("angel" or "seed") investors who may not be so concerned with valuation (for reasons discussed below), the inability to agree on valuation can be an insurmountable obstacle to attracting others.

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This article explores issues giving rise to disagreements about valuation and discusses possible strategies for avoiding these disagreements so that the fledgling company can get its money more quickly.

Common Stock and its Relationship to Valuation

The basic unit of ownership in a corporation is common stock. First-time entrepreneurs often think that it will be simplest and therefore fastest, to issue common stock to new investors.

Because the rights and obligations of common stockholders are dictated by state law, common stock is familiar, uncomplicated and in many instances can be issued with minimal documentation.

However, precisely because it is the basic unit of ownership, the price paid for a share of common stock translates directly into the value of the issuing company.

(Consider, for example, that references to "market capitalization" of a public company are simply the quoted price per common share multiplied by the total number of shares which have been issued.)

In a private, early-stage company, the price which seed investors pay for a share of common stock would likewise fix the value for the total number of shares outstanding and hence for the whole company.

Take, for example, our entrepreneur who wishes to raise $1 million. When she founded the company, she issued herself 30,000 shares. In order to raise the $1 million, she is telling the investors they will own 25 percent of the company after the investment ("post-money").

This will require the company to issue 10,000 additional shares, meaning there would be 40,000 shares outstanding after the investment (i.e., 10,000 shares equals 25 percent of 40,000 shares).

Thus, in order to raise $1,000,000, the price per share of common stock being paid by the investors would be $100, which would make the value of the 40,000 shares (i.e., the whole company) $4 million. This is the "post-money valuation" of the company.

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But if the entrepreneur varies the amount of the offering or the percentage of the company to be owned, the valuation will change.

For example, if the entrepreneur needs to raise $2,000,000 but this amount still is to represent only 25 percent of the company, the price per share would increase to $200 and the value of the company to $8,000,000.

Alternatively, if the seed round remains at $1,000,000 but the entrepreneur is only willing to give the investors 10 percent of the outstanding shares of the company after the investment, then the investors will only get 3,333 shares at $300 per share and the post-money valuation would be $10 million (3,333 shares equals 10 percent of 33,333 total shares, which at a value of $300 per share equals $10,000,000).

Setting a valuation is not only a matter of resolving differences between the entrepreneur and potential seed investors. It is the usual case with start-ups that significant additional funding will be required before the company becomes self-supporting or before a liquidity event.

Therefore, the higher the valuation is set in the seed round, the greater the risk that new investors may insist on a lower valuation for the subsequent round.

This would result in a “down round” on the basis of the lower valuation of the company, resulting in a reduction in the value of the seed investors’ investment. In a down round, on paper at least, the seed investors will thus have lost money.

Again, an example may make this clear. Assume that the company raised $1,000,000 of seed capital based on a $10,000,000 valuation and is back in the market seeking a Series A round. (This is generally the first round which a company raises from institutional investors such as venture capitalists.)

Because the entrepreneur believes the company has made significant progress with its seed capital, the proposal is to raise $10,000,000 based on a $25,000,000 post-money valuation.

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This implies that the pre-money valuation of the company has risen to $15,000,000 and the seed investors' investment (10 percent of the pre-money shares outstanding) is now worth $1,500,000.

However, if the Series A investors come back and say that they believe that the company is only worth $5,000,000 pre-money or $15,000,000 post-money, they will want two-thirds of the company for their $10,000,000 investment.

The effect of these terms would be to reduce the value of the angel investors' $1,000,000 investment to $500,000 pre-money (10 percent of $5,000,000) and their post-money percentage of the company to 3.3 percent. The need for a down round arose in part because such a high valuation was placed on the company in the seed round.

From the entrepreneur's vantage point, there is another aspect to the valuation problem. As noted above, accepting a low valuation of the company at an early stage means an entrepreneur either has to offer the seed investors a larger percentage of the company or reduce the dollar amount of the seed offering.

For instance, if an entrepreneur accepts that his company is valued at only $2,000,000, then to raise $1,000,000 he would have to give up 50 percent of the company. He may balk at this, fearing that he will be giving up management control.

Even more significant, he may be concerned that after further dilution from future investment rounds, the total dollars he will receive when the company is sold or there is a public offering (a "liquidity event") will be too small, making the whole project not worth his time.

Convertible Securities

To avoid an impasse with angel investors on valuations, it has become common practice for entrepreneurs to treat the angel round as a "bridge financing" and issue them a special form of convertible securities.

A more conventional convertible security (such as a bond or preferred stock convertible to common stock) specifies a particular dollar amount as the conversion price for the underlying security (e.g., the common stock).

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This conversion price, when divided into the face amount of a convertible note (or the aggregate purchase price or liquidation value of convertible preferred stock) yields the number of shares of the underlying security that the investor is entitled to receive upon conversion.

If this type of security were issued in the seed round of a start-up, however, the company and the investors with the same valuation issues described above.

Therefore, the company generally offers seed investors a security which does not convert directly into common stock, but instead converts into whatever type of security is purchased by the next round of Series A investors. Most such securities actually require conversion at the time the next round is raised.

As an example, the seed investor may acquire a note with such a conversion feature and a face amount of $100,000. Assume that the note states that the conversion price is 100 percent of the price per share to be paid by the Series A investors.

Thus, if the new investors purchase Series A Preferred Stock for $100 per share, the note holder would be receive 1000 shares of Series A Preferred Stock upon conversion.

By accepting such a convertible security in the seed round, the angel investors are essentially “pre-investing” in the Series A round, agreeing in advance that the money they used to purchase their convertible securities will ultimately result in the issuance to them of (in this case) Series A Preferred Stock.

The effect of this is to defer the valuation decision until the Series A round. By agreeing to accept Series A securities in exchange for their convertible securities, the seed investors are accepting whatever valuation is ultimately placed on the company by the Series A investors.

This may seem somewhat unfair to the seed investors, who (in the above example) have not been compensated for the extra risk they bear of losing their entire investment if the company cannot raise the Series A round.

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To address this issue, the conversion price offered to seed investors is generally discounted from the purchase price to be paid by the Series A investors.

To illustrate, in the previous example, if the bridge notes convert at a discount of 20 percent from the price paid by the Series A investors (discounts generally range from 10 percent to 30 percent), the seed investor's $100,000 note would convert at a price of $80 per share instead of $100 per share, and the noteholder would receive 1,250 Series A Preferred shares instead of 1,000.

The extra 250 shares would represent the seed investor's compensation for putting his money in at an earlier and riskier stage.

Seed investors may also receive a discount if the same purchase price they pay for the face amount of the bridge securities also gets them warrants to acquire securities in the Series A round for an exercise price equal to the Series A purchase price.

The amount of the discount ("warrant coverage") is expressed as a percentage of the principal amount of the convertible security.

For example, a convertible security with a purchase price of $1,000,000 and 25 percent warrant coverage means that the investors' warrants will permit them to purchase $250,000 worth of the same security purchased by the Series A investors at the same purchase price.

Additional negotiations may be required to fix the amount of any discount in the conversion price, as well as to determine any other terms of a bridge warrant.

For instance, the seed investors may insist that the percentage of the discount should rise the longer the note is outstanding (on the theory that the risk premium should be lower if the company closes the Series A round right away but higher if closing that round takes a long time).

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With warrants, negotiations may be required not only regarding the coverage percentage but also as to whether the exercise price itself should enjoy a discount from the Series A purchase price.

Regarding a discount in the exercise price, an entrepreneur must balance the demands of the seed investors with the possibility that potential Series A investors may be put off by the idea that the seed investors get the same securities for less, depending on the number of shares issuable to the seed investors.

These debates are about the relative value of the seed money to the Series A funding and not directly about valuation of the company. Therefore, negotiation of these issues at the seed stage is likely to be less difficult.

Convertible Notes vs. Convertible Preferred Stock

Although convertible notes are more familiar, they do raise certain issues which may be avoided by use of convertible preferred stock in the seed round.

For example, if the company issues convertible notes, do the notes bear interest? If there is to be interest, is the interest to be payable on a current basis? If it is to accrue, will the investor will have the right to convert the value of the accrued interest as well as the face amount of the note into Series A securities?

If the Series A round does not happen and the company runs out of money, will the terms of the notes permit the company to force conversion anyway? If so, at what price? Or will the note provide that the Company can compel an extension of the term of the note at a penalty interest rate?

Furthermore, seed round notes generally require that they be converted at the closing of the next round because Series A investors will not want their money used to pay those notes. However, the seed investors may want to set a floor on how much Series A money must be raised to trigger the forced conversion.

Many of these issues do not arise if convertible preferred stock is issued instead of notes. Such preferred stock is sometimes referred to as “super common,” meaning that its only preference over common stock is that the

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investors' purchase price is returned on a priority basis upon liquidation, if there are sufficient funds left over after paying the company's debts.

In all other respects (dividends, voting rights, etc.), this type of convertible preferred has the same rights that common stock does.

With "super common" stock, there is no requirement for fixed dividends (in place of interest) and no obligation of the company to repurchase (i.e., "repay") preferred stock. And because there is no repayment obligation, later investors need not be concerned if the seed investors' preferred stock remains in place after the Series A round.

Who is Investing?

Ultimately, the security to be offered by the entrepreneur will depend on the nature of the investor group whom the entrepreneur expects to attract.

"Angel investors" is a term which includes wealthy individuals investing on their own, organized groups of such individuals, and seed-oriented venture capital firms.

As noted above, some individuals and even some organized groups may be motivated to invest for reasons other than pure return on investment — they know and trust the entrepreneur or they have a particular interest in helping entrepreneurs in a field or market which has personal meaning to them, such as cancer research.

The trust element, coupled with the possibility of direct involvement with the company, may lead this type of angel investor to be less concerned with elaborate contractual protections or particular rights and powers related to the purchased security. They may go into the investment ready to write it off if things do not work out.

Professional angels and venture capitalists, on the other hand, tend to be more focused on return and have a less personal relationship with the entrepreneur. For them, return on investment is a more important factor and protecting that return may cause the investor to seek more elaborate contractual rights.

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In summary, successfully completing a seed capital round requires a clear understanding of the types of securities which may be issued, the pros and cons of each, and the types of investors most likely to invest in the company.

Although there are more typical and less typical transactions, one size definitely does not fit all. But entrepreneurs who do their homework will greatly increase their chances of success in getting an "angel on board."

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