

# HI-TECH: TERM SHEET NEGOTIATION DEBRIEF

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*MGMT 804*



# BACKGROUND

## Hi-Tech

- Founded by three graduate students from MIT: Kishore (CEO), Mary (CTO), and Robert (CFO)
- Provides a new personalized search engine technology: there is no competing product or technology in the space

## Galaxy

- Reputation of funding companies with leading edge technologies, and hence having strong expertise and network within the search engine industry
- Fairly congenial group, with history of rational dealings with the management teams of their startup companies
- Mixed financial performance amongst its portfolio companies

## Acorn

- Strong investment record in terms of financial performance
- Reputation of micromanaging their investment and firing the founding team for failure to meet the business plan objectives
- Not much expertise in search engine technology

# HI-TECH'S OBJECTIVES

Hi-Tech's goals going into the fundraising discussions (in order of priority):



- A high pre-money valuation, somewhere in the range of \$15mn for Galaxy, and \$20mn for Acorn; and quick access to funding



- “Mindshare” of the VC partners



- Retain voting control and day-to-day operating control of the new company



- Reasonable terms for liquidation preference and anti-dilution

# VCs INITIAL TERMS (1/2)

Item	Galaxy	Acorn
Pre-money Valuation	\$1.3M	\$19.4M
Current % of Ownership (Fully Diluted Share Basis)	79.9%	20.5%
Price Per Share	\$0.25	\$2.98
Liquidation Preference	2X , non-participating	2.5X, participating
Anti-Dilution	narrow-based	full-ratchet
Dividends	10% Cumulative	10% Cumulative, accrues quarterly
Board Structure	2 Series A + 1 CEO + 1 external director (jointly voted for)	3 Series A + CEO
CEO Stay	Likely	Definitely not stay within 6 months

# VCs INITIAL TERMS (2/2)

Item	Galaxy	Acorn
P/E Multiple	40	60
Time to IPO	6 years	5 years
Voting Right	Standard	Standard + Protective Provisions
Conditions of Investment	Paid in one tranche within 3 weeks	Two tranches for investment

# OUR NEGOTIATION STRATEGY

## Galaxy

- 👍 Expertise in technology
  - 👍 Access to portfolio company and LPs' networks
  - 👍 Accommodates management
- 

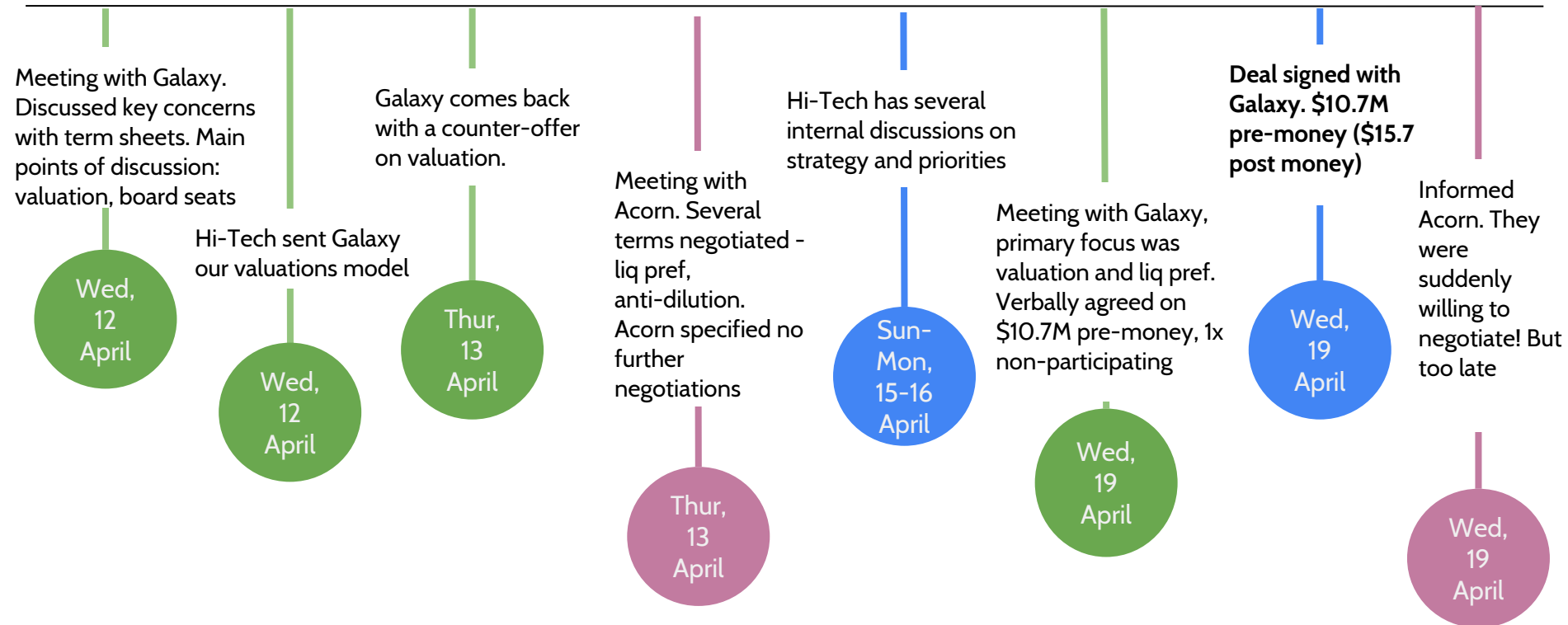
- 👎 Valuation
- 👎 Board Control
- 👎 Anti-Dilution
- 👎 Liquidation Preference

## Acorn

- 👍 Higher valuation
  - 👍 Successful track record
  - 👍 Significant returns
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- 👎 Founder CEO firing clause
- 👎 Board Control
- 👎 Anti-Dilution
- 👎 Liquidation Preference

# TIMELINE FOR DEAL CLOSURE



	Galaxy	Acorn
# of Meetings with VC (internal meetings: 4)	2	1
# of Emails	15	25

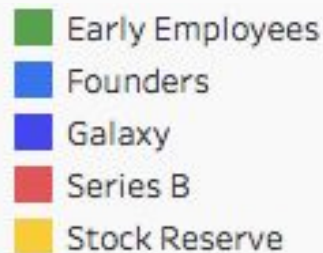
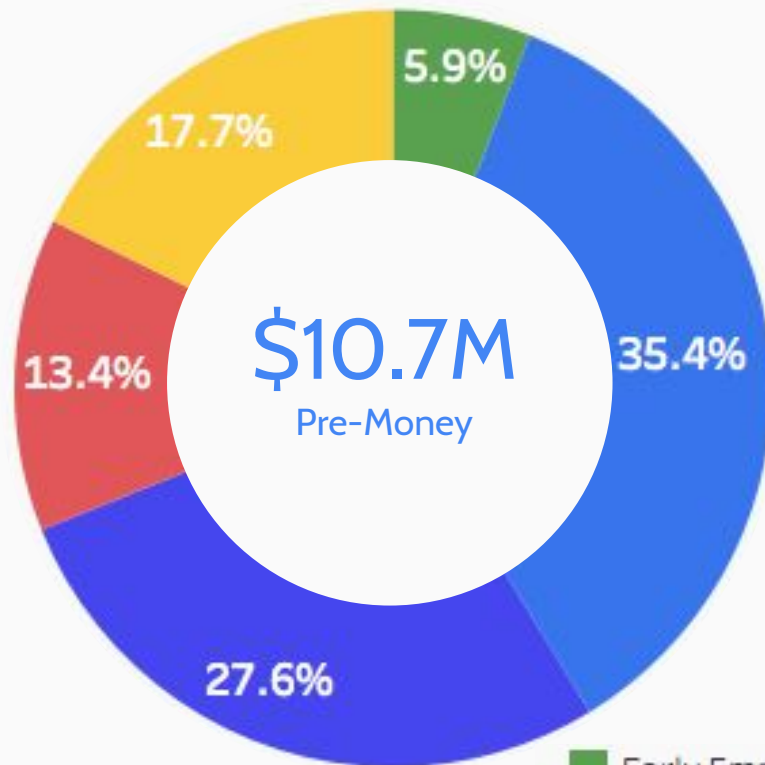
# HI-TECH'S VALUATION MODEL

	Galaxy	Acorn
Investment (R1)	\$5M	\$5M
Founders shares	3,000,000	3,000,000
Early Employees shares	500,000	500,000
Outstanding shares	1,500,000	3,000,000
P/E	55	61.4
IPO @ year end	5	5
Earnings@IPO	\$3.45M	\$3.45M
Terminal Value	\$189.75M	\$211.83M
Discount Rate	60.00%	50.00%
Investment (R2)	\$15M	\$10M
Year end	3	2
Discount Rate (Round 2)	30.0%	30.0%
Final % ownership for R2 VC	13.4%	10.4%
Retention Ratio (R1)	86.6%	89.6%
Final % ownership (R1)	27.6%	17.9%
Current % ownership (R1)	31.9%	20.0%
# of shares for R1 investor	2,341,173	1,624,826
# of shares for R2 investor	1,131,988	940,179
Final # of shares	8,473,161	9,065,005
Price/share (Round 1 Investor)	\$2.14	\$3.08
Price/share (Round 2 Investor)	\$13.25	\$10.64
<b>Post-Money Valuation</b>	<b>\$15.7M</b>	<b>\$25M</b>

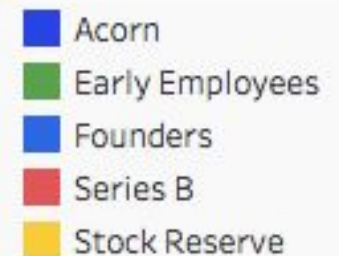
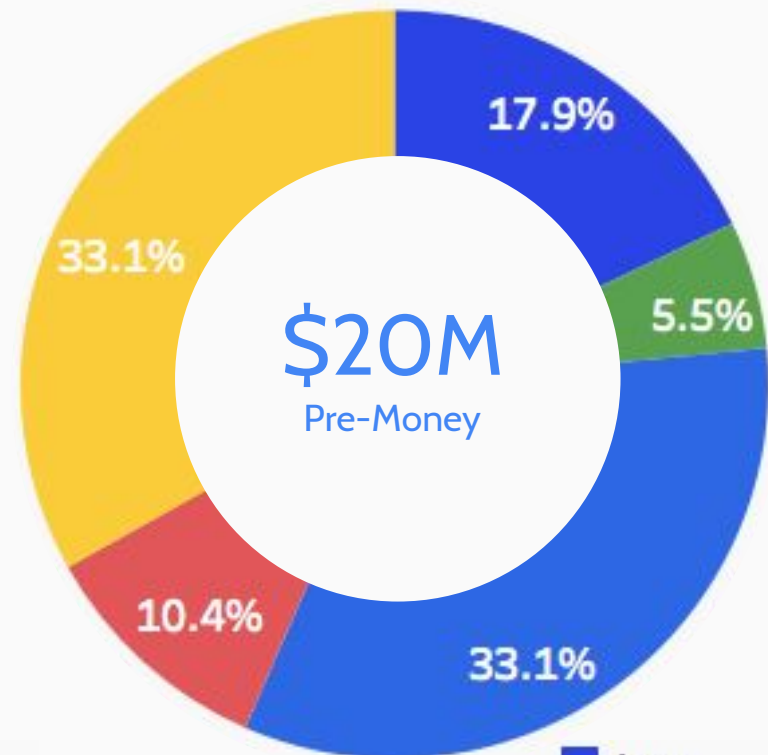


# LIQUIDATION SCENARIO: PAYOFFS

## Galaxy



## Acorn



# PAYOFFS : GALAXY DEAL

	# of Shares	% Owned	Invest	Liq. Pref.	If Hi-Tech gets sold at ...					
					\$20M	\$50M	\$100M	\$500M	\$1B	\$10B
Founders	3M	35.4%	--		0	\$11.8M	\$32.2M	\$174.8M	\$351.9M	\$3.5B
Early Employees	500K	5.9%	--		0	\$2M	\$5.4M	\$29.1M	\$58.6M	\$589.7M
Outstanding Stock	1.5M	17.7%	--		0	\$5.9M	\$16.1M	\$87.4M	\$175.9M	\$1.8B
Galaxy	2.3M	27.6%	\$5M	1x,non-p	\$5M	\$9.2M	\$25.1M	\$136.4M	\$274.6M	\$2.8B
				Dividend	0	\$3.1M	\$3.1M	\$3.1M	\$3.1M	\$3.1M
Series B	1.1M	13.4%	\$15M	1x,non-p	\$15M	\$15M	\$15M	\$66M	\$132.8M	\$1.3B
				Dividend	0	\$3.2M	\$3.2M	\$3.2M	\$3.2M	\$3.2M
TOTAL	8.5M	100.0%								

NOTE: Series B investors are assumed to have same Terms as Series A investors with discount rate = 30%

# PAYOFFS : ACORN DEAL

	# of Shares	% Owned	Invest	Liq. Pref.	If Hi-Tech gets sold at ...					
					\$20M	\$50M	\$100M	\$500M	\$1B	\$10B
Founders	3M	33.1%	--		0	\$9.4M	\$26M	\$158.4M	\$323.8M	\$3.3B
Early Employees	500K	5.5%	--		0	\$1.6M	\$4.3M	\$26.4M	\$54M	\$550.4M
Outstanding Stock	3M	33.1%	--		0	\$9.4M	\$26M	\$158.4M	\$323.8M	\$3.3B
Acorn	1.6M	17.9%	\$5M	1x,p	\$5M	\$10.1M	\$19.1M	\$90.8M	\$180.4M	\$1.8B
					\$1.6M	\$3.2M	\$3.2M	\$3.2M	\$3.2M	\$3.2M
Series B	940K	10.4%	\$10M	1x,p	\$10M	\$13M	\$18.1M	\$59.6M	\$111.5M	\$1.0B
					\$3.4M	\$3.4M	\$3.4M	\$3.4M	\$3.4M	\$3.4M
TOTAL	9.1M	100.0%								

NOTE: Series B investors are assumed to have same Terms as Series A investors with discount rate = 30%

# FINAL TERMS POST NEGOTIATION (1/2)

Item	Galaxy	Acorn
Pre-money Valuation	<del>\$1.3M</del> \$10.7M	<del>\$19.4M</del> \$20M
Current % of Ownership (Fully Diluted Share basis)	<del>79.9%</del> 31.9%	<del>20.5%</del> 20%
Price Per Share	<del>\$0.25</del> \$2.14	<del>\$2.98</del> \$3.08
Liquidation Preference	<del>2X, non-participating</del> 1X, non-participating	<del>2.5X, non-participating</del> 1X, participating
Anti-dilution	"narrow"-based	full ratchet "narrow"-based
Dividends	10% cumulative	10% cumulative, accrued quarterly
Board Structure	<del>2 Series A + 1 CEO + 1 external director (jointly voted for)</del> 2 Series A + CEO + 1 external director (appointed by Hi-Tech)	<del>3 Series A + CEO</del> 3 Series A + 2 Founders
CEO Stay	Likely	<del>Definitely not stay within 6 months</del> 18-months, performance based

# FINAL TERMS POST NEGOTIATION (2/2)

Item	Galaxy	Acorn
P/E Multiple	40 55	60 61.4
Time to IPO	6 years 5 years	5 years
Voting Right	Standard	Standard + Protective Provisions
Conditions of Investments	Paid in one tranche within 3 weeks	Two tranches for investment

# RATIONALE FOR FINAL DECISION

Item	Galaxy	Acorn
Pre-money Valuation	Lower, however more realistic	Higher Valuation
Liquidation Preference	Similar	Similar
Anti-dilution	Similar	Similar
Board structure	Similar	Similar
CEO Stay	Yes, without micromanaging	Potential to replace CEO
Cultural fit	Strong fit, good chemistry	Weak fit
Expertise & Network	Good resources in the industry	Only focus on return



*Galaxy a better option!*

# HI-TECH + GALAXY: DEAL SEALED!



## Sealing the Deal - Hi-Tech/Galaxy



Inbox x



**Mehta, Hena** <hena@wharton.upenn.edu>

12:50 pm (2 days ago)



to Jeffrey, Colin, Peter, Nathaniel, Juan, Dominik, Hao, Piyush, Minah, Tamanna

Hi Team Galaxy,

Great news - we are good to go with the **10.7M pre-money valuation** that we discussed, which gives us a post-money valuation of 15.7M for this round.

Additionally - please update the term sheet to also include the new liquidation preference term of **1x non-participating**.

We look forward to seeing the final term sheet, and to working together! Galaxy is a strategic partner for us and we are really excited to take Hi-Tech to the next level.

Regards,

Hena, on behalf of Team Hi-Tech



# TAKEAWAYS FROM FOUNDERS' PERSPECTIVE

## Fit

Besides the financial-related terms such as valuation, other factors such as **cultural fit and chemistry** play an important role

## Focus

It is important for founders to understand what they want to get out from a VC investment, and **strategize and prioritize** their negotiation discussions accordingly

## Mindset

Keep a **win-win mindset** during the negotiation process since VCs will eventually become the partner in their startup journey

## Power

The dynamics show that **founders have more power** during the negotiation process given they are approached by multiple VC funds