Session # 4: Identifying the right financial instruments for your technology company
26 May 2020
13:00- 14:00 (GMT +1)

Hosted by ITC, EQUALS, IoTask and UC Berkeley
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Founder at Combinate Capital
Representative to the EQUALS Leadership Coalition
Chair, GEIT Working Committee under EQUALS
Research Fellow and Director Special Projects, PCRI

• Extensive experience enabling innovation clients. Client work focuses on the creation of innovation centers, investment vehicles and industry engines.
• Board Director, Advisor and Founder of several successfully exited entrepreneurial technology companies.
• Led pre-founding design of intra-preneurial projects such as MIT Opencourseware, MIT Engine, MIT Auto-ID Center.
• Private equity professional at The Carlyle Group and management consultant at Booz Allen & Hamilton.
There is no one answer as to what funding to pick.
There is no right answer as to what funding to pick.
The right answer depends on you!
This talk is about helping you understand the trade-offs so you can make a decision.
Evaluating the tradeoff and obligations will help you decide.
Preferred Equity, Preferred Debt, Convertible, Safe Etc.
Anyone in the flow of money can fund

Many different products and vendors
  - Grant, Venture, Buyout etc.

Many different structures
  - Equity, Debt etc.

Investors fund
- What they understand and
- What fits their own business model
<table>
<thead>
<tr>
<th>SOURCES</th>
<th>PRODUCTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seed Capital</td>
<td>Equity</td>
</tr>
<tr>
<td>Venture</td>
<td>Debt</td>
</tr>
<tr>
<td>Growth Equity</td>
<td>Convertible Equity</td>
</tr>
<tr>
<td>Buyout</td>
<td>Preferred Equity</td>
</tr>
<tr>
<td>Lender</td>
<td>Preferred Debt</td>
</tr>
<tr>
<td></td>
<td>SAFE</td>
</tr>
<tr>
<td></td>
<td>Warrants</td>
</tr>
</tbody>
</table>
Note:
The Government is Elon Musk’s “VC”!

Note:
Bloomberg was funded by his customer Merrill!

Note:
Bose bootstrapped on government contracts!
• Lack of funding is one of the biggest causes of failure

• But the wrong type of funding is equally likely to curtail an enterprise

• Funding should be tuned to the lifecycle and growth path
WHAT IS FUNDING?

What are the Gives & Gets?

Thinking of Funding in Contractual Terms

Funder

Entrepreneur

Rights

Durations

Cash or Commitment

Security or Contractual Obligations

Terms

Duties

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## DIFFERENT CONTRACTS

<table>
<thead>
<tr>
<th>Capital Type</th>
<th>Gives &amp; Gets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Capital</td>
<td>- Security ownership</td>
</tr>
<tr>
<td></td>
<td>- Protective terms</td>
</tr>
<tr>
<td></td>
<td>- Incentive terms</td>
</tr>
<tr>
<td></td>
<td>- Control terms</td>
</tr>
<tr>
<td></td>
<td>- Investment</td>
</tr>
<tr>
<td>Debt Capital</td>
<td>- Note obligation</td>
</tr>
<tr>
<td></td>
<td>- Protective terms</td>
</tr>
<tr>
<td></td>
<td>- Control terms</td>
</tr>
<tr>
<td></td>
<td>- Investment</td>
</tr>
<tr>
<td>Pooled Capital</td>
<td>- Fund pool</td>
</tr>
<tr>
<td></td>
<td>- Contractual duties</td>
</tr>
<tr>
<td></td>
<td>- Contractual rights</td>
</tr>
<tr>
<td></td>
<td>- Commitment</td>
</tr>
<tr>
<td>Grant Capital</td>
<td>- Impact goals</td>
</tr>
<tr>
<td></td>
<td>- Governance terms</td>
</tr>
<tr>
<td></td>
<td>- Grant</td>
</tr>
<tr>
<td>Customer Capital</td>
<td>- Contractual duties</td>
</tr>
<tr>
<td></td>
<td>- Contractual rights</td>
</tr>
<tr>
<td></td>
<td>- Consideration</td>
</tr>
<tr>
<td>Donation Capital</td>
<td>- Goal commitment</td>
</tr>
<tr>
<td></td>
<td>- Governance terms</td>
</tr>
<tr>
<td></td>
<td>- Donation</td>
</tr>
</tbody>
</table>
The **capital structure** is the particular combination of **debt** and **equity** used by a **company** to finance its overall operations and growth.

**Debt** comes in the form of bond issues or loans, while **equity** may come in the form of common stock, preferred stock, or retained earnings.
EQUITY VS DEBT

- Equity Capital represents the investment of the owner(s) in the business.
- Is called risk capital because investors assume the risk of losing their money if the business fails.
- Does not have to be repaid with interest like a loan does.
- Means that an entrepreneur must give up some ownership in the company to outside investors.

- Debt Capital must be repaid with interest.
- Is carried as a liability on the company’s balance sheet.
- Can be just as difficult to secure as equity financing, even though sources of debt financing are more numerous.
- Can be expensive, especially for small companies, because of the risk/return tradeoff.

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### Type of capital

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Debt</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Voice in management&lt;sup&gt;a&lt;/sup&gt;</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Claims on income and assets</td>
<td>Senior to equity</td>
<td>Subordinate to debt</td>
</tr>
<tr>
<td>Maturity</td>
<td>Stated</td>
<td>None</td>
</tr>
<tr>
<td>Tax treatment</td>
<td>Interest deduction</td>
<td>No deduction</td>
</tr>
</tbody>
</table>

<sup>a</sup> Debtholders do not have voting rights, but instead they rely on the firm’s contractual obligations to them to be their voice.
PAYOFF OF CLAIMS

PAYOFF SEQUENCE
- First Debt
- Second Equity

Diagram showing the payoff to claimholders with two sections: Debt and Equity. The value of the company changes from debt investors to equity and debt investors as V(T) increases.
WHAT IS A TERM SHEET?

WHY IS THIS IMPORTANT?
If you accept capital the you will be obligated as per Terms

A contractual OFFER for debt, equity and rights

Terms
- Security
- Valuation
- Proceeds
- Price per share
- Liquidation preference
- Conversion
- Voting rights
- Board rights
- Pro-rata rights

Rights
- Economic rights
- Control rights
- Governance rights

Obligations
- Consideration

TERMS FOR PRIVATE PLACEMENT OF SERIES SEED PREFERRED STOCK OF

[INSERT COMPANY NAME], INC.

[Date]

The following is a summary of the principal terms with respect to the proposed Series Seed Preferred Stock financing of [ ] Inc., a Delaware corporation (the "Company"). Such summary of terms does not constitute a legally binding obligation. Any other legally binding obligations will only be made pursuant to definite agreements to be negotiated and executed by the parties.

Issuance Terms
- Shares of Series Seed Preferred Stock of the Company (the "Series Seed").
- Aggregate Proceeds: $[ ] in aggregate.
- Investors: Accredited investors approved by the Company (the "Investors").
- Price Per Share: Price per share (the "Original Issue Price"), based on a pro-money valuation of $[ ] including an available option pool of [ ]%.
- Liquidation Preference: One times the Original Issue Price plus declared but unpaid dividends on each share of Series Seed, balance of proceeds paid to Common. A merger, reorganization or similar transaction will be treated as a liquidation.
- Conversion: Convertible into one share of Common (subject to proportional adjustments for stock splits, stock dividends and the like) at any time at the option of the holder.
- Voting Rights: Votes together with the Common Stock on all matters on an as-converted basis. Approval of a majority of the Preferred Stock required to (i) adversely change rights of the Preferred Stock; (ii) change the authorized number of shares of Preferred Stock; (iii) authorize any new class of series of Preferred Stock having rights senior to or on parity with Preferred Stock; (iv) redeem or repurchase any shares, rather than pursuant to the Company’s right of redemption at original cost; (v) declare or pay any dividend; (vi) liquidate, dissolve including any change of control; or (vii) change the authorized number of directors.

Documentation:
- Documents will be on Series Seed Preferred Stock documents published at www.seriesseed.com.
- Financial Information: Investors who have invested at least [ ] ($[ ] "Major Investors") will receive standard information and inspection rights and management rights letter.
- Participation Right: Major Investors will have the right to participate on a pro rata basis in subsequent issuances of equity securities.
- Board of Directors: Two directors elected by holders of a majority of common stock. One director elected by holders of a majority of Series Seed.
- Expenses: Company to reimburse counsel to investors for a flat fee of $10,000.
- Future Rights: The Series Seed will be given the same rights as the next series of Preferred Stock (with appropriate adjustments for economic terms).
- Founder Matters: Each founder shall have four years vesting beginning [ ] Full acceleration upon "Double Triggers". Each Founder shall have assigned all relevant IP to the Company prior to closing.
• Convertible has features of Debt and Equity
• Convertible is most commonly used first round funding

• Convertible notes often include a valuation cap and/or conversion discount.
  
  • A **valuation cap** sets a maximum valuation—for purposes of determining the price per share—at which an investor’s money converts into equity, even if investors in the priced round agree to and pay a different price per share based on a higher valuation.
  
  • A **conversion discount** gives investors a discount on the price per share—compared to other investors buying shares in the same priced round—when their convertible note converts into equity.
CONVERTIBLE DEBT OR BOND

PAYOFF

TERMSHEET

TERMS

• Offering Size:
• Conversion Price:
• Conversion Ratio: (based on par value of)
• Coupon Rate and YTM:
• Maturity: Date (tenor)
• Payments:
• Optional Redemption:
• Change of Control:
• Settlement:
## SAFE VS. CONVERTIBLE

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Convertible Note</th>
<th>SAFE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nature of the obligation</td>
<td>Debt</td>
<td>Warrant/Convertible security</td>
</tr>
<tr>
<td>Interest rate</td>
<td>Yes, usually 2 to 8%, with an average at 5% in practice</td>
<td>No</td>
</tr>
<tr>
<td>Maturity date</td>
<td>Yes. Once the maturity date is reached: (i) the company must pay back the principal and the interest, or (ii) convert the debt into equity and issue shares to the investor.</td>
<td>No</td>
</tr>
<tr>
<td>Valuation caps, discounts and most-favored nations clauses</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Event triggering the conversion</td>
<td>Upon the occurrence of a qualifying event: either a current or future/next financing round or the sale of the company, or upon agreement between the parties</td>
<td>A future/next financing round</td>
</tr>
<tr>
<td>Early exit</td>
<td>Possible to include a payout in case of change of control: 2x payout</td>
<td>Possible to include a payout in case of change of control: 1x payout or conversion into shares at the cap amount to participate in the buyout can be provided</td>
</tr>
</tbody>
</table>
CROWDFUNDING
- A way to finance a company or project via crowd-sale of tokens
- Starts at seed stage or even earlier!!!
- But raise could run into hundreds of millions
- Donations are accepted (usually in BTC or ETH) to pay dev

ICO
- Investors receive tokens in proportion to their investment
- Tokens are traded on exchanges and used for projects
UNDERSTANDING RISK: WRITE-DOWN RATES

The Venture Capital Funnel

US Loan Delinquency Rates %

<table>
<thead>
<tr>
<th>Delinquency Rates</th>
<th>all</th>
<th>credit card</th>
<th>others</th>
<th>leases</th>
<th>c&amp;i</th>
<th>Agricultural</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>2.28</td>
<td>2.54</td>
<td>2.07</td>
<td>0.95</td>
<td>1.09</td>
<td>1.60</td>
</tr>
<tr>
<td>2017</td>
<td>2.18</td>
<td>2.42</td>
<td>1.96</td>
<td>1.00</td>
<td>1.52</td>
<td>1.50</td>
</tr>
<tr>
<td>2016</td>
<td>2.00</td>
<td>2.16</td>
<td>1.82</td>
<td>0.94</td>
<td>1.49</td>
<td>1.07</td>
</tr>
<tr>
<td>2015</td>
<td>2.01</td>
<td>2.12</td>
<td>1.92</td>
<td>0.72</td>
<td>0.74</td>
<td>0.80</td>
</tr>
<tr>
<td>2014</td>
<td>2.32</td>
<td>2.32</td>
<td>2.33</td>
<td>0.83</td>
<td>0.90</td>
<td>1.06</td>
</tr>
<tr>
<td>2013</td>
<td>2.56</td>
<td>2.65</td>
<td>2.50</td>
<td>0.83</td>
<td>1.11</td>
<td>1.23</td>
</tr>
</tbody>
</table>

US Real Estate Delinquency Rates %

<table>
<thead>
<tr>
<th>All</th>
<th>residential</th>
<th>commercial</th>
<th>farmland</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>2.18</td>
<td>3.49</td>
<td>0.75</td>
</tr>
<tr>
<td>2017</td>
<td>2.42</td>
<td>3.91</td>
<td>0.79</td>
</tr>
<tr>
<td>2016</td>
<td>3.02</td>
<td>4.80</td>
<td>0.97</td>
</tr>
<tr>
<td>2015</td>
<td>4.04</td>
<td>6.23</td>
<td>1.41</td>
</tr>
<tr>
<td>2014</td>
<td>5.32</td>
<td>7.77</td>
<td>2.21</td>
</tr>
<tr>
<td>2013</td>
<td>7.23</td>
<td>9.75</td>
<td>3.67</td>
</tr>
</tbody>
</table>

**SOCIAL & CULTURAL ISSUES IN VC**

- Overwhelming homogeneity in the VC environment
- Women, Minorities get extraordinarily limited amounts of capital
- Most of the funding is concentrated in the early seed stage investment

**VC Funding (all)**

- **CEOs**
  - Men: 97%
  - Women: 3%

- **FOUNDERS**
  - Men: 97%
  - Women: 3%

- **SEED FUNDING**
  - 67%
  - 33%

- **LEADERSHIP**
  - 90%
  - 10%

Firms founded by Women received less than 3% of start-up capital and Firms founded by African American's less than 1%.

CONCLUSION

• There is no one answer as to what funding to pick.
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We provide visionary, innovative, actionable consulting and advisory services guiding our clients in:

- ‘Out of the box innovation’ thinking for areas like IoT
- A complete “Vision to execution” process
- Building new products
- Creation of Innovation of Things centers & eco-systems

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