



Basic Principles of Equity Financing for Biotechnology Companies

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Class Outline

- 1 – Understanding the Charter of a VC-Funded Company
- 2 – Representing the Company in Seeking Venture Capital
- 3 – Representing the VC in Making Venture Capital Investments
- 4 – IPO and Representing the Public Company



Understanding a Charter

Quick review...

- Who drafts the charter?
- Who can amend the charter?
- Where can you find a charter?
- What's in a charter?

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Lux Biosciences, Inc.

How many shares of common stock and preferred stock does Lux have authorized? How many shares of common stock and preferred stock does Lux have issued and outstanding?

Authorized (source: Certificate of Amendment, Aug 31, 2006)

63,998,168 shares of common stock

50,000,000 shares of preferred stock

Outstanding – ???

(but, can determine maximum shares on "fully-diluted, as-converted" basis)

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If you own 95,000 shares of Lux common stock, what is your percentage ownership of the company?

$$\sim 0.15\% (= 95,000 / 63,998,168)$$

Note: when issued, shares represented 1% ownership of the company... what happened?



How much (in dollars) is the total venture capital investment in Lux? If Pfizer offers to buy Lux for \$100 million, how much (in aggregate dollars) will the founders and employees get? What if the offer is \$50 million? What if the offer is \$250 million?

If \$100,000,000... (source: Section 3 – Liquidation Rights)

$$\begin{aligned} \text{Preferred} &= \$50,000,000 + ((50,000,000 / 63,998,168) \times \$50,000,000) \\ &= \$89,063,618 \end{aligned}$$

$$\begin{aligned} \text{Common} &= \$100,000,000 - 89,063,618 \\ &= \$10,936,382 \end{aligned}$$



If \$50,000,000... (source: Section 3 – Liquidation Rights)

Preferred = \$50,000,000

Common = \$0

If \$250,000,000... (source: Section 3 – Liquidation Rights)

*Preferred = \$50,000,000 + ((50,000,000 / 63,998,168) x \$200,000,000)... but
not more than 3x \$50,000,000*

=\$150,000,000 – NO!

= (50,000,000 / 63,998,168) x \$250,000,000 = \$195,318,090

Common = \$250,000,000 - 195,318,090 = \$54,681,910

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What are the most important differences between the rights of the preferred stockholders and the rights of the common stockholders?

- class voting (Section 2(b)-(d))
- liquidation rights (Section 3)
- anti-dilution protection (Section 5(h))

... but note “pay to play” in Section 6(b)

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VC Term Sheet

When representing the company in seeking venture capital, focus on:

1 – How much money?

- What are the near to medium term milestones that will step-up value, and what is the expected cost to achieve those milestones?
- What is the current “pre-money” valuation, and is this adequate to compensate founders, protect prior investors and compensate employees and consultants?
- What is the likely future availability of additional funding?

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VC Term Sheet

When representing the company in seeking venture capital, focus on:

2 – Which VCs?

- Does the VC have expertise to offer strategic advice?
- Does the VC have resources to supplement management?
- Does the VC have the ability and commitment to meet future funding requirements?

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VC Term Sheet

When representing the company in seeking venture capital, focus on:

3 – Key deal terms?

- Pre-money valuation and employee pool
- Liquidation preference (participation and/or caps)
- Board composition (number and identity of directors)
- Vesting of founders' stock

Note: examine model language in NVCA Term Sheet and consider whether the company's concerns are likely to be addressed; also, consider why are other terms often are not as critical

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VC Term Sheet

Why is all of this needed? *misalignment of interests*

Founders

- Develop a novel therapeutic and bring to market/patients
- Salary and immediate compensation
- Authority to create desired working environment
- "Escape" from Big Pharma
- Potential "equity kicker"

VCs

- Return on investment (ROI): size, timing

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- 1 – How does a venture capital firm work? (who are the investors, how does the management firm's compensation work, what is the fiduciary duty, how is an investment mandate developed, how are investment opportunities selected (qualities of technology, qualities of management, existing capitalization, etc.), etc.)
- 2 – What are often the key deal terms for the venture capital firm?
- 3 – Brief overview of suite of NVCA Model Documents



Frank Castellucci –

- 4 – Typical Series A deal terms... what does Atlas Venture typically see?

Compare (and explain variance): last week, Dow Jones VentureWire reported (for July 2006 – June 2007):

- Median ownership percentage sold to investors (38%, down from 50% in prior year)
- In most deals, liquidation preference is 1x (non-participating)
- Full ratchet anti-dilution in only 16% of deals
- Pay-to-play provisions in only 21% of deals (declining from 37% over past 3 years)



“Going Public”

Basic background in applicable law... Securities Act of 1933–

Sec 4(2): “The provisions of section 5 shall not apply to... transactions by an issuer not involving any public offering.”

Sec 5(c): “***It shall be unlawful for any person, directly or indirectly,*** to make use of any means or instruments of transportation or communication in interstate commerce or of the mails ***to offer to sell*** or offer to buy through the use or medium of any prospectus or otherwise ***any security, unless a registration statement has been filed as to such security,*** or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8.”

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“Going Public”

Regulation D (venture capital, angel financing, etc.)

- Rule 506 – compliance through investor representations in stock purchase agreement and filing Form D and “blue sky” forms
- Other safe harbors for sales to limited numbers of unaccredited investors – private placement memorandum

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“Going Public”

Registration Statement on Form S-1 (some key elements)

- Risk Factors
- Description of the Business
- Financial Statements
- Management’s Discussion and Analysis of Financial Condition and Results of Operations (consider trends, reasonable likelihood, materiality... compare with objectives of Risk Factors and Description of the Business)
- Executive Compensation and Affiliated Transactions
- Underwriting
- Material contracts (subject to confidential treatment)

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Why Go Public?

Pros

liquidity for existing investors
additional capital on favorable terms
other strategic value? (currency for M&A, prestige, etc.)

Cons

expense – \$1-2 million plus underwriters’ discount
management time (documents, roadshow, etc.)
uncertainty of success
new investors may have different strategic objectives
costs of ongoing compliance

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'34 Act and SOX

Securities Exchange Act of 1934 requires periodic updating of information in S-1

- Annual Report on Form 10-K
- Quarterly Report on Form 10-Q
- Current Report on Form 8-K
- Proxy statement for meeting electing directors
- Section 16 reporting

Sarbanes Oxley Act of 2002

- Enhanced financial disclosure (off balance sheet, pro forma, etc.), auditor independence, assessment of internal controls and CEO/CFO certifications, Board composition, penalty enhancement

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