Lecture 12

Venture Capital Glossary

Mustafa Ergen

Frequently Asked Questions About Venture Capital

- **What kind of investors are venture capitalists?** Venture capitalists are professional investors who specialize in funding and building young, innovative enterprises. Venture capitalists are long-term investors who take a hands-on approach with all of their investments and actively work with entrepreneurial management teams in order to build great companies.

- **Where do venture capitalists get their money?** Most venture capital firms raise their "funds' from institutional investors, such as pension funds, insurance companies, endowments, foundations and high net worth individuals. The investors who invest in venture capital funds are referred to as "limited partners." Venture capitalists, who manage the fund, are referred to as "general partners." The general partners have a fiduciary responsibility to their limited partners.

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- **How many venture capital firms are there in the U.S.?** There were approximately 794 venture capital firms in the United States in 2009; these firms manage approximately $179 billion.
- **What's the average size of a venture capital fund?** In 2009, the average venture fund size was $151 million.
- **How many companies receive venture capital financing each year?** In 2009, venture capitalists invested approximately $18 billion into nearly 2,400 companies.

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- **What types of companies and industries do venture capitalists invest in?** Venture capitalists invest mostly in young, private companies that have great potential for innovation and growth. Venture capitalists have been instrumental in developing sectors such as the computer, biotechnology and the communications industries. Today, the majority of venture capital is invested in high technology companies including software, biotechnology, medical devices, media and entertainment, wireless communications, Internet, and networking. In the last five years, the venture industry has also committed itself to investing in the clean technology sectors which include renewable energy, environmental and sustainability technologies and power management. However, venture capitalists also invest in innovative companies within more traditional industries such as consumer products, manufacturing, financial services, and healthcare services and business products and services.

Frequently Asked Questions About Venture Capital

- **What impact does venture capital have on the economy?** Venture capital activity has a significant impact on the U.S and global economies. Venture capital is a catalyst for job creation, innovation, technology advancement, international competitiveness and increased tax revenues. According to the 2009 Venture Impact study, produced by IHS Global Insight, originally venture-backed companies accounted for 12.1 million jobs and over $2.9 trillion in revenue in the United States (based on 2008 data).

- **How are venture capitalists different from other investors?** Venture capitalists are long-term investors who take a very active role in their portfolio companies. When a venture capitalist makes an investment he/she does not expect a return on that investment for 7-10 years, on average. The initial investment is just the beginning of a long relationship between the venture capitalist and entrepreneur. Venture capitalists provide great value by providing capital and management expertise. Venture capitalists often are invaluable in building strong management teams, managing rapid growth and facilitating strategic partnerships.

Frequently Asked Questions About Venture Capital

- **How do venture capitalists realize a return on their investment?** The companies that venture capitalists invest in are private enterprises. Typically, the venture capitalist realizes a return on their investment when the company goes public (IPO) or is merged or purchased by another company (M&A).
- **What percentage of venture-backed companies succeed?** Venture capitalists invest in high-risk enterprises. However, venture capitalists manage that risk through portfolio risk management. It is estimated that 40 percent of venture backed companies fail; 40 percent return moderate amounts of capital; and only 20 percent or less produce high returns. It is the small percentage of high return deals that are most responsible for the venture capital industry consistently performing above the public markets.

Frequently Asked Questions About Venture Capital

- **How does angel investing differ from venture capital?** Venture capital firms are professional investors who dedicate 100% of their time to investing and building innovative companies on behalf of third party investors or their limited partners. The angel investment community is a more informal network of investors who invest in companies for their own interests. Typically, angel investors invest less than $1 million in any particular company, whereas venture capitalists usually invest more than $1 million per company.

Frequently Asked Questions About Venture Capital

- **What's the difference between venture capital and private equity?** Venture capital is a subset of the larger private equity asset class. The private equity asset class includes venture capital, buyouts, and mezzanine investment activity. Venture capital focuses on investing in private, young, fast growing companies. Buyout and mezzanine investing focuses on investing in more mature companies. Venture capitalists also invest cash for equity. Unlike buyout professionals, venture capitalists do not use leverage in their transactions.

- **What impact does corporate venture investing have on the venture industry?** Many corporations have been active venture capital investors for many years. Corporate venture capitalists often co-invest with traditional venture capitalists. Besides being savvy investors, many corporate venture capitalists provide their portfolio companies access to corporate distribution channels and potentially important strategic partners.

Venture capital glossary of terms

- Angels: High net worth individuals who provide seed money to very early stage companies, usually investing their own money rather than that of institutional or other investors.
- Anti-dilution provisions: Provisions which protect the holder's investment from dilution as the result of later issues of shares at a lower price than the investor paid by adjusting the option price or conversion ratio or issuing new shares.
- As converted basis: the determination of preferred shares rights, such as vesting and participation in a dividend, on the basis that those shares have been converted into ordinary shares, taking account of whatever adjustments might be necessary.
- Audit Committee: A committee of the Board of Directors consisting of a majority of independent (non-executive) directors, responsible for selecting and overseeing the work of outside auditors and other audit activities. The definition of an independent director may vary from one market to another.

Venture capital glossary of terms

- Bridge loan, bridge finance or bridge round: A loan or equity investment to provide financing for a relatively short time period until the issuer can complete a longer term financing such as a public offering or new investment round.
- Burn rate: The rate at which a company is consuming cash each month.
- Capitalise: Converting a debt owed to a company into equity.
- Capitalisation table (cap table): A spreadsheet listing all shareholders and holders of options and any other securities, along with the number of shares, options and convertible securities held.
- Carried interest: The portion of any profits realised by a venture capital fund to which the fund managers are entitled, in addition to any returns generated by capital invested by the fund managers. Carried interest payments are customary in the venture capital industry. Also known as the carry.

Venture capital glossary of terms

- Completion or closing: In the context of a venture capital investment round, the release of investment funds to the company and the issuance of shares to the investors following execution of the investment documents and verification that all necessary conditions have been fulfilled.

- Co-investment: See Syndication.

- Conversion: The act of exchanging one form of security for another security of the same company, e.g. preferred shares for ordinary shares, debt securities for equity.

- Conversion ratio: The ratio indicating the number of underlying securities that can be acquired upon exchange of a convertible security, e.g. the number of ordinary shares into which preferred shares are convertible (see paragraph 6, Section IV above).

- Convertible debt: A debt obligation of a company which is convertible into shares.

Venture capital glossary of terms

- Convertible preferred shares: Preferred shares convertible into ordinary shares.
- Co-sale or Tag along rights: A mechanism to ensure that if one investor or founder has an opportunity to sell shares the other shareholders are also given that opportunity on a proportional basis.
- Covenants: Undertakings given to the investors by the company and sometimes the founders to do or not do certain acts.
- Cumulative dividends: A dividend which accumulates if not paid in the period when due and must be paid in full before other dividends are paid on the company's ordinary shares.
- Cumulative preferred shares: A form of preferred shares which provides that if one or more dividends is omitted, those dividends accumulate and must be paid in full before other dividends may be paid on the company's ordinary shares (see paragraph 3, Section IV above).
- Debt/equity ratio: A measure of a company's leverage, calculated by dividing long-term debt by ordinary shareholders' equity.

Venture capital glossary of terms

- Debt financing: Financing by selling notes or other debt instruments.
- Deed of adherence: An agreement that purchasers of shares (new or existing) may be required to sign to ensure they are bound by the terms of an Investment Agreement.
- Deemed liquidation or liquidity event: Term used to describe trigger events for a liquidation preference. Usually defined to cover, among other things, a merger, acquisition, change of control or consolidation of the company, or a sale of all or most of its assets.
- Default: Failure to discharge a contractual obligation, e.g. to pay interest or principal on a debt when due.
- Demand registration rights (US): The contractual right of a security holder to require an issuer to file a registration statement to register the holder's securities so that the holder may sell them in the public market without restriction.

Venture capital glossary of terms

- Dilution: The process by which an investor's percentage holding of shares in a company is reduced by the issuance of new securities.
- Directors & officers insurance: Directors and officers (D&O) insurance is professional liability coverage for legal expenses and liability to shareholders, creditors or others caused by actions or omissions by a director or officer of a company.
- Disclosure letter: A letter given by the founders, and maybe other key members of the management team, and the company to the investors setting out exceptions to the representations and warranties.
- Discounted cash flow (DCF): An investment appraisal technique which takes into account both the time value of money and also the total profitability of a project over a project's life.
- Divestment: The disposal of a business or business segment.
- Dividends: When a company makes a profit, it can pay part of these profits to its shareholders in the form of cash, additional shares or other assets. Such payments are known as dividends.

Venture capital glossary of terms

- Down round: A round of venture capital financing in which the valuation of the company is less than the previous round.
- Drag along/bring along: A mechanism ensuring that if a specified percentage of shareholders agree to sell their shares, they can compel the others to sell ensuring that a prospective purchaser can acquire 100% of a company.
- Due diligence: The process of researching a business and its management prior to deciding whether to proceed with an investment in a company.
- Early stage capital: Finance for companies to initiate commercial manufacturing and sales, following receipt of seed capital.
- Earnings: Profits after expenses.

Venture capital glossary of terms

- EBIT/EBITDA: Earnings before interest and taxes/earnings before interest, taxes, depreciation and amortisation: financial measurements often used in valuing a company.
- Employee share option plan (ESOP): A scheme to enable employees to acquire shares in the companies in which they work.
- Equity: Ownership interest in a company represented by shares.
- Exclusivity Agreement: Often negotiated by a syndicate of investors, an agreed period of exclusivity during which the company and/or its existing shareholders cannot negotiate with others for investment into the company.
- Exercise price: The price at which an option or warrant can be exercised.
- Exit mechanism: Term used to describe the method by which a venture capitalist will eventually sell out of an investment.

Venture capital glossary of terms

- Exit strategy: Potential scenarios for liquidating an investment while achieving the maximum possible return. For venture capital-backed companies, typical exit strategies include Initial Public Offerings (IPOs) and acquisitions by or mergers with larger companies.
- Flotation: To obtain a listing or IPO on a stock exchange.
- Follow-on investment round: An additional investment by existing and/or new investors, which may be provided for in documentation relating to the initial investment.
- Founder shares: Shares issued to the founders of a company, usually at a low price in comparison to that paid by investor. See also Sweat equity.
- Full ratchet: Anti-dilution provisions that apply the lowest sale price for any ordinary shares (or equivalents) sold by the company after the issuing of an option or convertible share as being the adjusted option price or conversion price for those options or shares.

Venture capital glossary of terms

- Fully diluted share capital: The issued share capital of a company if all options and other rights to subscribe for shares are exercised.
- Fully participating: Term sometimes used to describe a liquidation preference which entitles beneficiaries to receive a priority initial fixed payment and share pro rata with other share classes in any remaining proceeds.
- Generally accepted accounting principles (GAAP): Rules and procedures generally accepted within the accounting profession.
- Good leaver/bad leaver: A criteria applied to a shareholder employee who is ceasing to be employed to determine whether his shares should be subject to a compulsory sale, and if so, at what price.
- Independent or outside director: A non-executive member of the Board of Directors who is not an employee of a company nor affiliated with a controlling stockholder of a company. The definition of independent may be further defined in different countries or markets.

Venture capital glossary of terms

- Information rights: The contractual right to obtain information about a company, attend board meetings, etc. typically received by venture capitalists investing in privately held companies.
- Initial public offering (IPO): The sale of shares to the public by a company for the first time. Prior to an IPO, companies that sell shares to investors are considered privately held. This is the first time that a company has tried to raise funds on a public market such as a stock exchange. Terms used to describe this are flotation, float, going public, listing when a company obtains a quotation on a stock market.
- Institutional investor: An organisation whose primary purpose is to invest assets owned by the organisation or entrusted to them by others. Typical institutional investors are banks, pension funds, insurance companies, mutual funds and university endowments.
- Intangibles: The non-physical assets of a company that have a value, e.g. intellectual property rights including trademarks and patents.
- Intellectual property (IP): Legal term used to describe the patents, licences, copyrights, trademarks and designs owned by a company.

Venture capital glossary of terms

- Internal rate of return (IRR): An accounting term for the rate of return on an asset. It is defined as the interest rate that equates the present value of future returns to the initial investment. It is greatly affected by the timing of the exit.
- Investment Agreement: This is a summary of the main terms of the investment into the company. Typically it will describe the amounts and types of shares to be issued and the specific rights of the investors such as veto rights and information rights.
- Key man insurance: Insurance obtained by the Company on the lives of key employees, usually the chief executive officer and the person or persons ultimately responsible for continuing to develop the technology.
- Lead investor: In a substantial investment, the whole risk is often shared among a syndicate. Normally, one investor will take the lead in negotiating the terms of the investment and managing due diligence.

Venture capital glossary of terms

- Licence Agreement: An agreement under which certain commercial and/or intellectual property rights may be used by the licensee, for example the institution may licence intellectual property rights to the investee company.
- Liquidation or winding up: The sale of all of a company's assets, for distribution to creditors and shareholders in order of priority. This may be as a result of the insolvency of the company or by agreement amongst shareholders.
- Liquidation preference: A negotiated term of a round of venture capital financing that calls for certain investors to have all or most of their entire investment repaid if the company is liquidated. Often also triggered by a deemed liquidation.
- Liquidity: Converting an asset (such as shares) to cash.
- Listing: When a company's shares are traded on a stock market it is said to be listed.

Venture capital glossary of terms

- Lock-up: A provision in the Underwriting Agreement between an investment bank and existing shareholders that prohibits corporate insiders and private equity investors from selling for a certain period of time following a public offering (usually 180 days after an IPO).
- Milestone: A contractual target that must be met by the company. Often used by investors as a condition for releasing further amounts of financing.
- Net present value (NPV): The current value of future cash flows discounted back to today's date using a stated discount rate.
- NewCo: Word often used to describe a newly formed investee company.
- New money: Investment funds coming from an investor who is not a current shareholder of the company.

Venture capital glossary of terms

- Non-executive director: Part-time directors who share all the legal responsibilities of their executive colleagues on the Board of a company. The general view is that they can operate as an independent director able to take a long-term view of a company and protect the interests of shareholders. An investor will often appoint a non- executive to a board as one way of monitoring its investment.
- Non-qualified IPO: An IPO which is not a qualified IPO.
- Options: The right, but not the obligation, to buy or sell a security at a set price (or range of prices) in a given period.
- Ordinary shares: These are equity shares that are entitled to all income and capital after the rights of all other classes of capital and creditors have been satisfied.
- Outside director: See Independent or outside director.
- Par: The nominal cash amount assigned to a security by the issuer. For an equity security, par is usually a very small amount that no longer bears any relationship to its market price.

Venture capital glossary of terms

- Pari passu: Equally, rateably, without preference. Generally used to describe securities which are to be treated as being of equal priority or preference.
- Participating preferred shares: Preferred shares which entitle the holder not only to its stated dividend and liquidation preference, but also allows the holder to participate in dividends and liquidating distributions declared on ordinary shares.
- Patent: The exclusive right to make, use or sell an invention or a process for a specific period of time.
- Pay to play: A provision which requires investors to participate in subsequent rounds or forfeit certain rights such as anti-dilution.
- Piggy-back registration rights (US): Contractual rights granted to security holders giving them the right to have their holdings included in a registration statement if and when the issuer files a registration statement.

Venture capital glossary of terms

- Post-money valuation: The value of a privately held company immediately after the most recent round of financing. This value is calculated by multiplying the company's total (fully diluted) number of shares by the share price of the latest financing.

- Pre-emption right: The right of an investor to participate in a financing to the extent necessary to ensure that, if exercised, its percentage ownership of the company's securities will remain the same after the financing as it was before. Sometimes also used as a term for a right of first refusal on shares of other investors.

- Preferred ordinary shares (UK): These may be known as A ordinary shares, cumulative convertible participating preferred ordinary shares or cumulative preferred ordinary shares. These are equity shares with preferred rights. Typically they will rank ahead of the ordinary shares for income and capital. Once the preferred ordinary share capital has been repaid, the two classes may then rank pari passu in sharing any surplus capital. Their income rights may be defined; they may be entitled to a fixed dividend (a percentage linked to the subscription price, e.g. 8% fixed) and/or they may have a right to a defined share of the company profits – known as a participating dividend (e.g. 5% of profits before tax).

Venture capital glossary of terms

- Pre-money valuation: The value of a privately held company prior to the most recent round of financing.
- Put option: A contract whereby the holder of the option has the right to sell to the grantor shares at a specific price (strike price) at some time in the future.
- Qualified IPO: An IPO which gives the company a market capitalisation of at least a certain amount (often a multiple of the valuation at the time of an investment) and is accompanied by a fully underwritten fund raising of a certain amount.
- Recapitalisation: The reorganisation of a company's capital structure by the infusion of new cash and/or the replacement of current shareholders by new ones. Recapitalisation can be an alternative exit strategy for venture capitalists.

Venture capital glossary of terms

- Ratchets: A structure whereby the eventual equity allocations between the groups of shareholders depend on either the future performance of the company or the rate of return achieved by the venture capital firm. This allows management shareholders to increase their stake if the company performs particularly well.
- Redeemable shares: Shares which the company can be made to repurchase or which the company has the right to repurchase at a predetermined value.
- Registration rights (US): The contractual right of a shareholder to participate in the registration of the issuer's stock for resale in the public market.
- Remuneration Committee or Compensation Committee: A committee of the Board of Directors responsible for reviewing and setting the remuneration of certain executive officers of the company. The Remuneration Committee may also be responsible for the allocation of share options to employees. A Remuneration Committee is typically comprised of a majority of independent directors of the company.

Venture capital glossary of terms

- Representations and warranties: Terms in an Investment or Subscription Agreement whereby usually the founders and key managers and (subject to local company law) the company give undertakings in respect of the past and present operating condition of a company. Examples include operating in a legal fashion, no bad debts, ownership of assets. Breach of warranty gives the investors the right to claim damages and, if it is sufficiently fundamental, may enable the investors to terminate the contract.

- Restrictive covenants/non-competes: Undertakings given by founders/key management in the Investment Agreement and contracts of employment or Consultancy Agreements which restrict their ability to undertake activities which might compete with the company both during their employment/consultancy and post termination of employment in order to protect the business and the value of the company.

- Right of first refusal (ROFR): A contractual right, frequently granted to venture capitalists, to purchase shares held by other shareholders before such shares may be sold to a third party.

- ROI: Return on investment.

Venture capital glossary of terms

- Secured debt/loan: Loan, where the lender, in the event of a failure to meet either an interest or principal payment, gains title to specific assets.
- Seed capital: Capital provided to allow a business concept to be developed, perhaps involving the production of a business plan, prototypes and additional research, prior to bringing a product to market and commercial large-scale manufacturing.
- Series: A round of venture capital financing. Each sequential round is distinguished by a letter: A, B, C, etc.
- Shareholders' Agreement/Investor Rights Agreement: Many of the rights between shareholders in a company are set out in its Articles of Association. This is a public document that is filed at Companies House. In many cases shareholders will want to create rights and obligations between them that they would prefer to keep confidential. In such cases, rather than put those rights and obligations into a public document they will enter into private contractual arrangements, in a document such as a Shareholders' Agreement. If the agreement also includes terms relating to the subscription for shares it will often be referred to as the Investment Agreement.
- Share option: An agreement providing for the purchase or sale of shares within a stipulated time and for a certain price.

Venture capital glossary of terms

- Subscription Agreement: A Subscription Agreement sets out the terms upon which an investor will subscribe for shares in a company. If the agreement also includes terms relating to shareholders' rights it may also be described as an Investment Agreement (see Section II above).
- Sweat equity: Equity (shares in a company) which is given to the founder of the company in recognition of the effort (sweat) which he has expended in getting the company started up.
- Syndication: An arrangement whereby a group of investors come together to invest in an investment proposition which they would not be prepared to consider individually whether because of risk or amount of funding required. There is however usually a lead investor.

Venture capital glossary of terms

- Trade sale: Sale of a company to another company. As a form of exit, it is an alternative to flotation and more common.
- Trade secret: Information, such as a formula, pattern, device, or process, that is not known to the public and which gives the person possessing the information a competitive advantage. May sometimes include customer lists, marketing and/or business plans, and details of suppliers and customers.
- Tranching: Investment made in stages; each stage being dependent on achievement of targets or milestones.
- Transfer restrictions: Restriction of the sale of shares by founders, management or investors for a predefined period of time or until certain conditions have been fulfilled.
- Use of proceeds: The purpose to which the company intends to use the funds raised from new investors. The investment documentation often stipulates that the funds must be used for this purpose.

Venture capital glossary of terms

- Vesting: Where an employee or consultant has been granted rights to receive options or has been issued shares which are subject to his completing a specific length of service or achieving certain milestones, the options or shares will have vested when the period or milestone has been satisfied. Once vested the employee or consultant is entitled to exercise those options to obtain shares or to receive full rights to the shares.

- Warrant: Another word for an option to purchase a security. The term is generally used for options provided by the company to outside investors (as distinct from officers, employees, etc.).

- Weighted average: Anti-dilution provisions that apply a weighted average formula to adjust the option price or conversion ratio of an early-round investor, based on the sale price and number of equivalent shares sold by the company after the issuing of the option or convertible security.

Reference

- A guide to Venture Capital Term Sheets by BVCA