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Understanding Equity and Convertible Notes

Biz + Bites Lunch Series

Will Bernat, Co-Lead, Food and Beverage Group, Nutter

September 22, 2020

Food and Beverage Industry Group

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- **All aspects of high growth brand companies, including:**

Who We Serve—Emerging Brands

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THE HAPPY, HEALTHY Watermelon Road SNACK CO.

MIGHTY SQUIRREL
CELEBRATE MIGHTY MOMENTS

EAT YOUR COFFEE

BOU
VEGETABLE

bohana

THE LIVING APOTHECARY™
nourish the body • feed the soul

LOCO
COFFEE CO.

dress it up
DRESSING

nomi™
fresh fruit & oat bar

Who We Serve—Growth Stage Brands

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BUFF BAKE

CALIFORNIA Cali'flour FOODS FRESH

DRINK SIMPLE™

BE IN YOUR element

FUEL FOR FIRE®

HARBOR SWEETS® HANDMADE CHOCOLATES

Hälsa

TASTE THE ADVENTURE

KALAHARI BILTONG

polkadogbakery

ELECTROLYTE NY | 16 ROAR Organic INFUSIONS

SCOTT & JON'S®

BY CHEATING GOURMET

UPTIME

willie's superbrew 4.5% ABV

wicked good Cupcakes

WANDERING BEAR COFFEE CO.

Who We Serve—Large Scale Brands

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CATANIA OILS

CEDAR'S

FOUNDED IN 1950
DiLUIGI FOODS

KING ARTHUR FLOUR

LALLEMAND

TÍO JUAN'S MARGARITAS Mexican Restaurant

Muffin Town
Home Town Goodness Since 1978

TUSCAN BRANDS

Acquired / Strategic Investment / Mergers

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Brewla CRAFT ICE POPS

Merged with Ruby's Naturals

Honest tea

Acquired by Coca-Cola

Deep River Snacks

Acquired by Arca

Häns Kissle WELCOME HOME

Acquired by Mitsui & Co., Ltd.

bai

Acquired by DPSG

RUNA

Acquired by AMI

MAKER™

KOMBREWCHA

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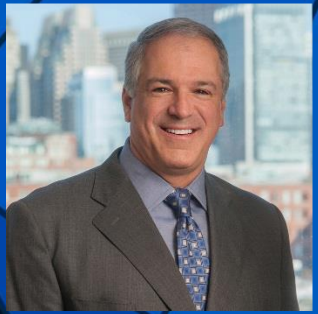

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Nutter

- **Nutter:**
  - Partner, Corporate & Transactions Department
  - Co-Chair, Emerging Companies Group
  - Co-Lead, Food and Beverage Group
- Represents companies in the following industries:
  - Consumer/Retail
  - Food & Beverage
  - Information and Technology
  - Medical Devices

- Focuses on the following areas: private equity, venture capital, and angel financing transactions, as well as mergers and acquisitions, commercial lending transactions, and other corporate governance issues
- Counseled clients in angel and venture backed financings representing an aggregate of over $250 million in investment in local early stage companies.
- **The Capital Network**: Partners' Committee
- **MassChallenge & Golden Seeds**: Mentor
- Providence College, B.A. and Suffolk University Law School, J.D.

What is Equity?

- The right to certain economic interests and control rights in the company.

- When used generically, the term Stock or Equity includes all Classes of Stock, such as Common Stock and Preferred Stock.

Authorized vs. Outstanding

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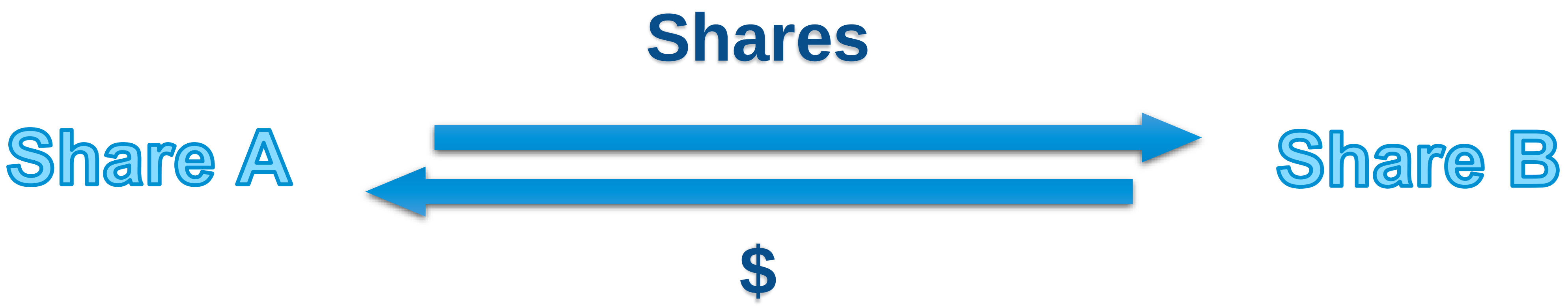
Authorized

The maximum number, Classes and Series of shares the Company might be hypothetically divided into – very limited practical effect – mostly regarding franchise tax calculation

Outstanding

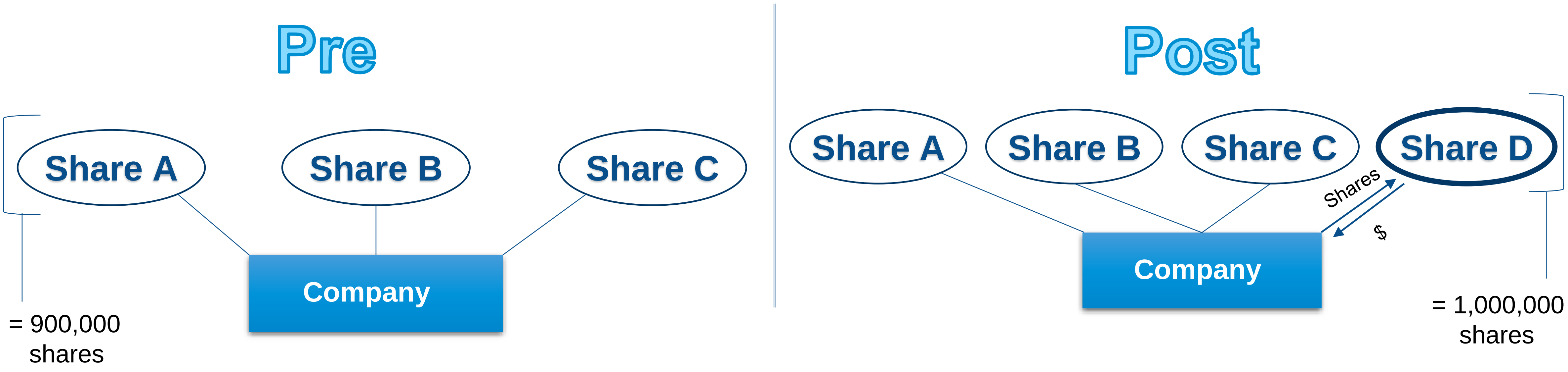
The shares of stock actually issued (and not repurchased) by the Company.

Transfer



- No $ to company
- No change in company’s capitalization
- No dilution

Issuance



- $ (or services) to company
- Company value increased
- Dilution

Common vs. Preferred

Common Stock

- *Vanilla, base level equity*. Issued to founders and the team (and maybe some early investors). Equity that is entitled to 100% of the assets of the company upon its liquidation after paying ALL creditors and senior equity.

Preferred Stock

- *Investor equity*. Equity that receives a senior (that is, “preferred) return, prior to the payment of the Common Stock, on (i) dividends, and (ii) liquidation.

Restricted Stock and Options

Restricted Stock

- Recipient receives shares of Stock
- Typically has same rights as other shareholders
- Subject to risk of forfeiture (“reverse vesting”)
- Taxable upon vesting (or earlier filing of 83(b) election with IRS)

Stock Options

- Right to purchase stock in the future at a price set today
- Not a stockholder until option is exercised
- Non-qualified stock options vs. Incentive stock options
- Taxable upon exercise
- Strike price must be at least equal to FMV

Vesting

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Vesting

- Crucial for retaining employees/service providers
- Requires employees/service providers to remain with the company for agreed upon length of time in order to get full benefit of equity compensation
- Typical – 25% after 1 year, and then the rest ratably in periodic (monthly/quarterly) installment over the remaining 3 years
- Can be tied to milestones
- Should consider for founders as well (***<u>Investors may require it</u>***).

Acceleration

- Single Trigger
- Double Trigger
- Termination without Cause/for Good Reason

Preferred Stock

Liquidation Preference

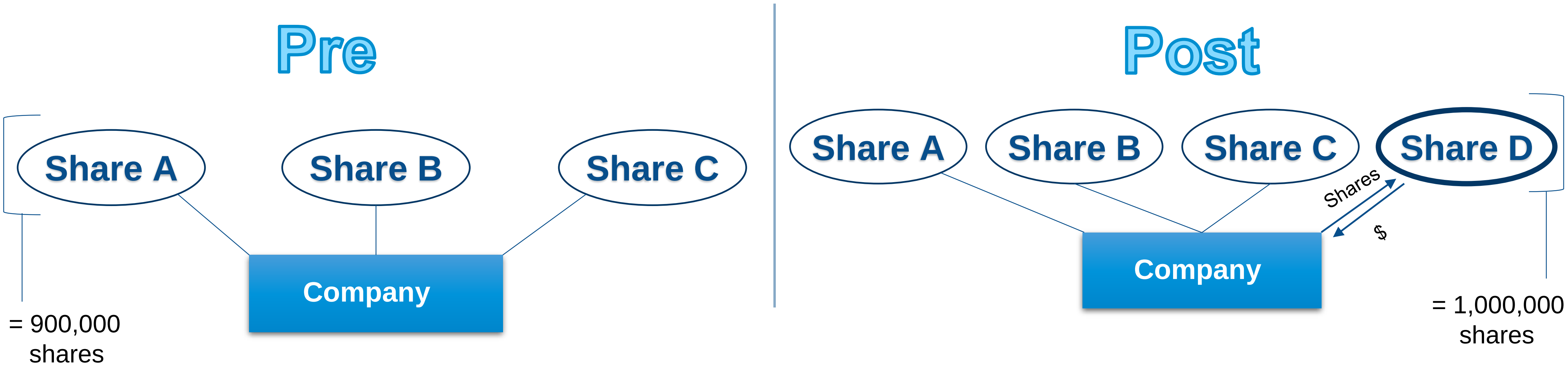
- Right to be paid before other classes of stock (downside protection)
  - Sometimes expressed as a multiple (i.e, 1.5x or 2.0x of invested capital)

- Dividends
  - A negotiated annual rate of return

- Participating/Non-Participating
  - Knowing the difference between **OR vs. AND**
    - Money Back **AND/OR** pro-rata % ownership

- Anti-Dilution Protections
- Redemption Rights
- Control Rights
  - Board level/shareholder level

Issuance, Again



- $ to company
- Company value increased
- Dilution

Calculating Deal Effect

Pre Money Value	$900,000
Pre Shares	900,000 Shares
Price Per Share (PPS)	$900,000 / 900,000 Shares = $1/Share
New Money	$100,000
Post Money	$900,000 + 100,000 = $1,000,000
New Shares	$100,000 / $1/Share = 100,000 Shares
Post Shares	900,000 + 100,000 = 1,000,000 Shares
Existing Holders % of Post	900,000 / 1,000,000 = 90%
New Investors % of Post	100,000 / 1,000,000 = 10%

Cap Table Illustration

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PRE	Shares	%
Founders	900,000	100%
New Money	0	0%
	900,000	100%

POST	Shares	%
Founders	900,000	90%
New Money	100,000	10%
	1,000,000	100%

Option Plan Effect

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BUT WAIT… WE HAVE A PLAN

… AND IT'S NOT A GOOD THING

Calculating Deal Effect

Pre Money Value	$900,000
Pre Shares	(900,000 + 100,000) = 1,000,000 Shares
Price Per Share (PPS)	$900,000 / 1,000,000 Shares = $0.90/Share
New Money	$100,000
Post Money	$900,000 + 100,000 = $1,000,000
New Shares	$100,000 / $0.90/Share = 111,111 Shares
Post Shares	900,000 + 100,000 + 111,111 = 1,111,111 Shares
Existing Holders % of Post	900,000 / 1,111,111 = 81.0%
Option Plan % of Post	100,000 / 1,111,111 = 9.0%
New Investors % of Post	111,111 / 1,111,111 = 10.0%

Cap Table Illustration 2 w/ Equity Plan

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PRE

	Shares	%
Founders	900,000	90%
Plan	100,000	10%
New Money	0	0%
Total	*1,000,000*	*100%*

POST

	Shares	%
Founders	900,000	81%
Plan	100,000	9%
New Money	111,111	10%
Total	*1,111,111*	*100%*

Priced Equity - Summary

- Investors buying a known percentage at the closing
- Requires the parties to agree on valuation
  - For CPG – often looks at historical not future performance
- Control Rights
- Weighted Average Anti-Dilution
- Alignment on next round pricing

Convertible Notes – Structure &Thesis

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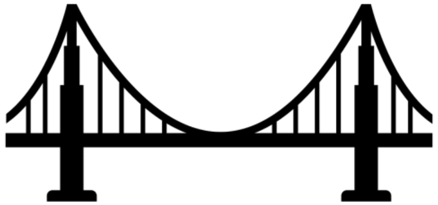
- Investors (“Lenders”) provide capital to the Company for an indeterminate amount of equity based upon subsequent events
- The investment is treated as a debt of the Company, unless and until the debt is converted into equity
- The debt is designed to be a bridge to the next priced equity round (“bridge, not a pier”) where the debt will convert



Convertible Notes – Structure &Thesis

- For investing earlier (i.e., taking additional risk) note investors will get a better deal than the future equity investors

- By not pricing the equity at the time of the transaction, it allows the Company to build value before conversion

Convertible Notes – Key Terms

- **Interest** – Notes bear simple interest typically from 5-10% APR
- **Balloon** – All interest and principal are payable/convertible only upon specified events – there are typically no interim payments
- **Seniority** – Note is typically unsecured and automatically subordinated to all bank debt
- **Prepayment** – Typically not permitted
- **Maturity** – Note is due/convertible at a specific date – typically 12-24 months from issuance.

Convertible Notes – Key Terms cont.

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- **Cap** – The highest price used to convert the debt
  - Caps are good for investors; bad for Company
  - Higher cap is better for Company
  - Presence of a Cap is market
  - In CPG Cap can be fixed OR floating = multiple of LTM

- **Discount** – If converted in connection with a future financing, a discount against the price paid by next investors
  - Fixed – Typically 5-20%; OR
  - Inclining – Starting at [5%] and increasing over time to max of [20%]

Convertible Notes – Conversion Types

- Maturity – Ideally <u>automatically</u> converts at some multiple of LTM (usually lower than Cap multiple)
  - <u>Failure to be automatically converted can lead to big risks</u>

- Sale – Investors repaid in cash the higher amount equal to (i) conversion at default/maturity price or (ii) 1.5-2.0x Debt

- Qualified Financing – Automatically converts at lower of (i) discounted new price or (ii) Cap

- Non-Qualified Financing – Optionally convertible at lower of (i) discounted new price or (ii) Cap

Convertible Notes - Summary

- Cheaper to document
- Raise as you go (“higher velocity”)
- Investors buying an <u>unknown</u> percentage at the closing
- Does <u>not</u> require the parties to agree on valuation
  - May need to agree on Caps / Default Pricing – Multiples may be self correcting For CPG – often looks at <u>future</u> performance
- Limited Control Rights
- Full Ratchet Anti-Dilution
- Dis-alignment on next round pricing
- Interest and Discount Effects consumer value (i.e., increase dilution)
- Need to account for pay at maturity scenario

SAFEs

- Simple Agreement for Future Equity
- Eliminates many of the downsides/risks of Convertible Notes
  - No Maturity Date
  - No Interest Rate
  - Not Debt
- Newer, may require more investor education

Terms Related to Equity for Private Companies

Stock/Equity	The right to certain economic interests and control rights in the company. When used generically, the term Stock includes all Classes of Stock, such as Common Stock and Preferred Stock (see below). ▪ Equity's economic interests are subordinate to the interests of creditors. ▪ Therefore, in any liquidating distribution of Company assets, all loans, vendors claims, customer claims, lawsuits, etc., must be paid before the equity gets anything. ▪ Control rights are, without the addition of contracts, typically limited to (i) the election of the Board of Directors (not the executives), (ii) certain corporate transactions such as mergers and sales of the Company or its assets, and (iii) changes to the Company's Charter (see below) that adversely impact a particular Class or Series of Stock.
Share	In some states this is synonymous with Stock (e.g., "Shareholders", not "Stockholders"). In most cases, the "share" also means the counting unit of Stock (e.g., "John owns 3 shares of Common Stock").

Terms Related to Equity for Private Companies

Class of Stock	Groupings of shares that bear similar rights, preferences and obligations. Usually, shares are divided into Common Stock and Preferred Stock.
Series of Stock	Describes features of a group of shares within a Class that bear similar rights, preferences and obligations. In almost all cases, Series only will apply to Preferred Stock and will be denoted in alphabetic order based upon the date of issuances (i.e., the first series issued will be Series A Preferred Stock, followed by Series B Preferred Stock, etc.).
Common Stock	Equity that is entitled to 100% of the assets of the company upon its liquidation after paying ALL creditors and senior equity (such as Preferred Stock).
Preferred Stock	Equity that receives a senior (that is, “preferred) return, prior to the payment of the Common Stock, on (i) dividends, and (ii) liquidation. In this context, Liquidation means both a traditional liquidation of the company’s assets in a “downside” sell off scenario, but also a sale or merger of the Company, regardless of whether there is little or enormous profit.

Terms Related to Equity for Private Companies

Preferred Stock (continued)	In the public market, preferred stock is often a junior debt like instrument that bears a fixed dividend coupon and has few if any rights. In the private company market, preferred stock often has (i) additional corporate control features (e.g., right to approve certain transactions etc.), (ii) bears accruing but unpaid cash dividends (typically 610%), (iii) has the right to convert into Common Stock, and (iv) bears the (hypothetical) right to be repurchased (i.e., redeemed) by the Company, usually 5 years from issuance, and, carries a Liquidation Preference, typically equal to its initial purchase price (or some multiple thereof), plus accrued but unpaid dividends. ▪ Immediately following the bubble, some Preferred Stock was issued with up to 10X liquidation preferences! That means an investment of $1m would entitle the investors to take the first $10m of liquidation proceeds!

Terms Related to Equity for Private Companies

Priority / Senior & Junior / Subordinate	Words that describe the order in which assets would be distributed by the Company. If a Class of Equity is “Senior” or “Prior” it will receive assets before any assets can be distributed to a “Junior” or “Subordinated” Class of Equity. ▪ Ex. Debt is senior to Equity. ▪ Ex. Preferred Stock is typically senior to Common Stock. ▪ Ex. Series A Preferred Stock is often subordinate to Series B Preferred Stock. The usual rule is “last money in, first money out.”
Pari Passu	Class of Equity that receives assets at the same time as another Class of Equity. ▪ Ex. If Series A and Series B Preferred were Pari Passu, each share of Series A and Series B would be entitled to the assets being distributed at the rate of 1 Share of Series A (or B) / All Shares of Series A + All Shares of Series B.

Terms Related to Equity for Private Companies

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Pro Rata	Allocated in accordance with the percentage ownership. If Series A is paid $100 and John owns 10% of the shares, John would receive $10 on a pro rata distribution.
Participating Preferred Stock	Preferred Stock that entitles holders to BOTH a Liquidation Preference and the right to then convert into Common Stock and participate, pro rata, in the distribution of the remaining company assets.
Waterfall	A spreadsheet calculation or provisions in a Charter showing the distribution of assets in accordance with their priority rights.
Charter / Certificate of Incorporation / Articles of Incorporation	**(“Charter” is used by most practitioners as the shorthand, regardless of the technical name in the jurisdiction of the Corporation.)** The legal document that describes certain fundamental characteristics of the corporation and the filing of which gives the corporation separate legal existence (and that all important limited legal liability). A Charter is filed with a particular state (the “jurisdiction of incorporation”) whose laws will substantially govern all matters related to shareholders.

Terms Related to Equity for Private Companies

Authorized Stock	The maximum number, Classes and Series of shares the Company might be hypothetically divided into – very limited practical effect – mostly regarding franchise tax calculation. This will typically appear in representations that the Company makes regarding its structure and on the face of all stock certificates.
Outstanding Stock	The shares of stock actually issued (and not repurchased) by the Company. Typically, this is the number of shares that is used to discuss VOTING INTEREST. ▪ Ex. If there was only one class of stock (and in the absence of any contractual changes), ownership interest and voting interest would be calculated as: - A holder's shares / all outstanding shares. ▪ Ex. If John owns 10 shares, out of 100 issued, John owns 10% of the outstanding shares of the Company. In any vote or distribution of assets, John would get 10%.

Terms Related to Equity for Private Companies

Reserved Stock	Stock that has been authorized, but reserved for issuance typically for issuance upon the exercise or conversion of Convertible Securities, including Employee Stock Options.
Convertible Securities	Contractual rights to acquire shares of equity, which the Company will authorize and reserve against the exercise of such rights. Examples are stock options, warrants and convertible debt. If Preferred Stock is convertible (mandatorily or voluntarily) into shares of Common Stock, the Preferred Stock is a form of Convertible Equity. ▪ Vested – A convertible security that has a present right by the holder to acquire equity. The exercise of such a security may be conditioned upon the payment of money, or the fulfillment of some other condition such as current employment at the time of exercise. ▪ Unvested – A convertible security that has a future (usually conditional) right by the holder to acquire equity.

Terms Related to Equity for Private Companies

Convertible Securities (continued)	▪ Exercise – The act of using the rights under an Option or Warrant to acquire Equity. It usually implies the payment of the Exercise Price and the delivery of any associated paperwork. ▪ Conversion / Exchange – The act of using the rights under a Convertible Security to acquire Stock. It usually implies the delivery of any associated paperwork. ▪ Conversion Price / Conversion Ratio – The rate at which Preferred Stock or another Convertible Security converts into Common Stock. - If expressed as a Conversion Price, the Conversion Ratio is usually achieved by dividing the initial price of the security by the then effective Conversion Price. - Various events (Downrounds, Splits, etc.) can adjust the Conversion Price upwards or downwards. Conversion Ratios are typically, but not always, set initially at 1:1 (i.e., the Initial Price and Conversion Price are the same).

Terms Related to Equity for Private Companies

Options	In the private company context, usually Convertible Securities issued to Employees and Directors entitling them to purchase Stock upon the payment of an amount called the "Exercise Price." ▪ The Exercise Price is the fair market value of the Stock on the day of the issuance of the Option. ▪ Options may be vested or unvested, typically based upon length of employment with the Company and/or certain performance metrics. Except for performance based vesting, these Options typically vest 25% after 1 year of service with the remaining vesting (monthly or quarterly) over another 36 months. ▪ Typically, Options are exercisable, once vested, for 5-10 years from the date of issuance. Typically, once employment is terminated, Options may be exercised for a limited period of time, often based upon whether the termination was voluntary or involuntary.

Terms Related to Equity for Private Companies

Warrants	In the private company context, these are typically Convertible Securities issued to vendors, lenders or other strategic partners. The Exercise Price may or may not be the Fair Market Value of the Stock on the date of issuance, although accounting issues arise if it is not.
Convertible Debt	The principal, and usually the accrued interest, on a debt which may, under certain conditions and at the option of the lender, be converted into Stock at some ratio. Many angel investors use this as a tool to invest without a fixed valuation – setting the ratio as a function (typically 80-90%) of the value of the Company in a later venture capital transaction.
In-the-Money	A Convertible Security with an Exercise Price less than the current fair market value of the underlying Stock. ▪ Ex. John has an Option with an Exercise Price of $.10/sh, where the Stock issuable upon the exercise of the Option is worth $2.00/sh.

Terms Related to Equity for Private Companies

Out-of-the-Money	A Convertible Security with an Exercise Price equal to or greater than the current fair market value of the underlying Stock. ▪ Ex. John has an Option with an Exercise Price of $1.00/sh, where the Stock issuable upon the exercise of the Option is worth $0.50/sh.
Fully Diluted Equity (sometimes abbreviated "FDE")	A calculation of the total division of positive Equity interests in a Company, i.e., typically used to calculate a holder's ECONOMIC INTEREST. Fully Diluted Equity is calculated as: ▪ All outstanding shares of Common Stock + ▪ Common Stock issuable upon conversion of all Preferred Stock + ▪ Common Stock issuable upon exercise of in-the-money Convertible Securities.

Terms Related to Equity for Private Companies

Fully Diluted Equity (sometimes abbreviated "FDE")	In some cases, Fully Diluted Equity will also include: ▪ Common Stock issuable upon exercise of out-of-the-money Convertible Securities, and/or ▪ Common Stock reserved for issuance under an approved Employee Stock Option Plan.
Pre-Money Valuation	The Fair Market Value of the whole of the Company issuing equity to investors, before accounting for the influx of the new cash. Usually determined by a private negotiation between the Company and investors.
Pre-Money Valuation per Share	The Pre-Money Valuation divided by the number of Fully Diluted Shares (usually including the shares issuable pursuant to a current or proposed Stock Option Plan).

Terms Related to Equity for Private Companies

Post-Money Valuation	**The Pre-Money Valuation plus the gross amount of invested cash (there is typically no deduction for the deal expenses in thinking about this number).**
Up-Round	A financing in which the Pre-Money Valuation per Share is larger than in the previous financing round.
Down-Round	A financing in which the Pre-Money Valuation per Share is less than in the previous financing round.
Flat-Round	A financing in which the Pre-Money Valuation per Share is the same as in the previous financing round. Note that if additional Convertible Securities have been issued in the interim between the two rounds, the same Pre-Money Valuation in those two deals will lead to different Pre-Money Valuations per Share.

Terms Related to Equity for Private Companies

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Stock Split	A legal mechanism whereby each single share of stock becomes some other number of shares. In the private company context, a stock split tends to have NO economic effect. It is akin to taking pie slices and reslicing them into smaller increments. It does not change who owns what. ▪ In the public company context it can often have impact upon the ability of a company to stay listed on an Exchange that has minimum per share price rules. A split of the Common Stock typically has a proportionate change to the price and quantity of any common Stock issuable under any Convertible Securities, so that there remains parity among all of the stockholders.
Securities Laws	Laws that govern the issuance and trading of Equity, Convertible Equity, and in some cases Debt. Securities Laws are issued by all 50 states, the Federal Government and foreign jurisdictions.

QUESTIONS?

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