

Forms of Organizations

Capital Structure

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Top Questions

1. Corporate Structures- pros and cons
2. What type of ownership are you going to give Investors?
3. What do you need money for?
4. How much do you need?
5. One round or two?
6. How much of the firm are you going to give Investors to get that cash?



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Options for Legal Entity

1. C-Corporation
2. S- Corporation
3. LLC – Limited Liability Corporation



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C - Corporation

- ▶ Most common
- ▶ Needed for institutional investors (VC's or Private Equity Groups)
- ▶ Advantages:
 - Can have different classes (types of stock)
 - Common Stock, Class A, Class B
 - Preferred Stock Class A, Class B



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C - Corp

- ▶ What is common stock vs. preferred.
- ▶ Common = ownership in the firm
- ▶ Attributes: Voting rights (can have add'l classes with not voting)
- ▶ Common Shareholders vote for board of directors and need to approve certain major transactions.
- ▶ Board then carries out the decision making for the firm on many operational issues.



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C - Corp

- ▶ Class A Common – 1 vote per share
- ▶ Class B – ½ vote per share, less dividends
- ▶ Class C – non -voting



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C - Corp

- ▶ Preferred stock – Not ownership
- ▶ Preferred in terms of dividends and in case of bankruptcy.
- ▶ Less risky for that reason



C - Corp

- ▶ What investors like:
- ▶ Convertible preferred. All the benefits of preferred but converts to common when that is advantageous.
- ▶ Disadv. C- Corp
- ▶ Double Taxation:
 - Corp taxes and Personal Taxes



S – Corporation & LLC

- ▶ Adv. – not double taxation
- ▶ All profits/loss runs through to shareholders directly.
- ▶ Good when losses
- ▶ Can be a problem when profits



S – Corporation

- ▶ Profits / losses run through to owners
- ▶ Can't have Institutional investors (must be individuals)
- ▶ Can't have preferred stock or other classes -- but can have voting and non-voting.
- ▶ Best for early years with losses and no instit. Investors or if just plan to run it and not have outside investors



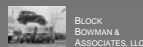
LLC – Limited Liability Corporation

- ▶ Not double tax
- ▶ Shareholders have Units (can be called shares) and Units can be defined as having specific characteristics
- ▶ Can't have instit. Investors
- ▶ Good when losses (early years) a bit harder to convert to C –Corp that a S-Corp would be.



Summary – Capital Structure

1. Plan to keep firm and not get outside investors or instit investors. S-Corp or LLC
2. Plan to raise VC or instit money soon – C-Corp
3. Plan to have losses in early years S or LLC
4. Once profits begin, often best to convert to C-Corp.



▶ What type of ownership for investors:

- Founders – common stock
- Others – convertible preferred or non-voting common



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Board Seats

- ▶ Investors will often want Board Seats
 - If you give up >50%, you give up control.
- ▶ Board seats are control



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Common shareholders voting rights.

- ▶ Shareholders elect the board, board appoints the top management for the firm.
- ▶ Shareholders commonly have 1 voting right per share. Can either vote or assign proxy (which is turn your vote over to another party)
- ▶ Voting common can be cumulative voting or straight voting (also called "majority" voting).



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Straight (Majority) Voting

- ▶ This type of voting precludes minority shareholders (own <50%) from electing a director. Here you may vote your total allocated # of shares for each director position which is open (ie. If own 100 shares and 1 vote per share, and 4 directors are being elected. Can vote up to 100 votes for each director position. Must vote for each director position, but can choose to vote < 100 votes for a position if so wish.



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Cumulative Voting

- ▶ Designed so minority interest shareholders can elect directors. Under this method,
- ▶ The total number of votes a shareholder may cast = # shares * number of votes per share (usually 1) * number of directors to be elected
- ▶ Once it is determined how many shares they may cast, shareholder can distribute the votes any way they wish (can vote all votes for one candidate or split them up.



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Cumulative Voting

- ▶ Ex. Own 100 shares stock with 1 vote per share
- ▶ there are 4 director positions open for which you may vote. You have a total of 400 votes to use in any way you wish. Can cast all 400 for one candidate, 200 each for two, or any other scenario as long as total votes = 400



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Staggered Board Terms

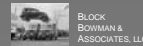
- ▶ Often will have directorship terms expire at staggered time periods. This is a safety precaution which: 1) makes takeover attempts less likely to succeed and 2) make it more difficult for minority interests to elect a director under cumulative voting



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Preemptive Rights

- ▶ Preemptive rights
- ▶ A provision that may be given shareholders which entitles existing common shareholders to maintain their % ownership in the firm. This simply gives existing shareholders the first opportunity to purchase (pro-rata) new stock being offered --- before new investors can purchase it.



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One Round or Two

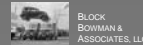
- ▶ Catch-22, if raise one round now (\$4 mill now) then will give up a greater % of the firm now – firm is less far along, so is valued at less. For instance may need to give up 60% of firm to get \$4 mill.
- ▶ If you wait a year, could potentially raise \$4 million and give up 25% of firm.



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One Round or Two - Options

1. First look at what you realistically could expect to raise now – perhaps the chances of even being able to raise \$4 mill now is slim or nil.
 2. Look at what you need just for the first 12 or 18 months. And see if you can raise that more easily with angels or friends and family. Then do second round when you are in a better negotiating position.
- ▶ No clear answer



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One Round or Two- Example

- ▶ First round
 - Start-up – value at \$1 mill and issue 1 million shares at \$1 per share.
 - Raise \$ 250,000 25%. Goes to investors
 - Founders keep 75%
- ▶ Two years later – firm is now worth about 5 million. Need to raise \$ 1 million – give up 20% of entire entity to do so

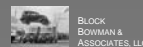


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- ▶ Will dilute existing shareholders – ie their ownership will be reduced proportionally.

- 75% 750,000 shares
- 25% 250,000 shares

- ▶ Need to issue additional 250,000 shares
- ▶ Now 1,250,000 outstanding

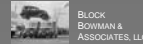


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- ▶ New investors get 250,000 shares for 1 million \$ = 20% of shares now outstanding
- ▶ But Founders now have 750,000 / 1,250,000 or 60% instead of 75%
- ▶ And first investors have 250,000 / 1,250,000 or 20%



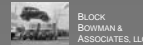
- ▶ Need to keep in mind the dilution ----
- ▶ Sometimes will have non-dilute clauses – in general not good for firm because will prevent ability to raise VC capital – hinder firm.



- ▶ Also need at some point to allocate shares to top management as an incentive. Can be options or actual stock (usually options) -- vest over time. One way to do this is set aside a percentage to use for this – perhaps 10 -15% of firm.
- ▶ Ie – new CFO gets 3% of firm in options but they vest over 5 years – Ie lets say 3% of firm is 3,000 shares for example (does not correlate with earlier example)
- ▶ Vesting can be set up at “cliff” – get it all at end of 5 years if still there, or stepwise – Ie 1/5 vests each year. So 600 options vest per year. If leave at end of one year get 600



- ▶ Option – right to purchase stock one or before a certain date at a certain price.
 - Not free.
- ▶ Give you the right to buy one share of stock for \$0.25 per share.
 - Only of value if current price per share of stock > 0.25.
- ▶ Let's say you have 600 options exercise price 0.25\$. Firm is sold for purchase price = 1.00 per share. You then do a cashless exercise and get 0.75 per share for your options.



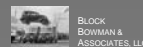
Capital vs Bootstrap

- ▶ Want to bootstrap for sure until you have created some barriers to entry and proprietary value (or use grants).
 - IP
 - Patents
 - product done
 - branding
 - Trademarks, copyrights
 - licensing agreements,
 - customers
 - beta tested



Capital vs Bootstrap

- ▶ Then it depends on your idea – some ideas timing is of essence and need to move fast and with full force before its too late – then need to raise capital and go for it. Ex. VOIP – many firms in field now, getting hot, if you have an idea here, can't take 18 months or two years to get it going. Need to be out there slugging for market share and strategic alliances now.
- ▶ Ability to raise capital – some ideas/firms are very difficult to raise capital for – such as retail, service, repackaging, etc..



Terms to Know

- ▶ Term Sheet
- ▶ Pre-money Valuation – what firm is worth before raising capital
- ▶ Post-money Valuation – add the cash it raised.
 - Ex: firm worth about 1 million but raises \$500,000 – now worth 1.5 million since has \$500,000 of cash on top of its original value



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How Much \$ is Needed- Need to Develop Projections

- ▶ Revenue
- ▶ Costs (Margins)
- ▶ Five years



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Need to develop rough projections over time

- ▶ Revenue projections
 - When does the revenue begin?
 - What will it be?
 - What is reasonable growth in revenue? (Infrastructure, Working Capital, etc..)



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Revenue Projections

- ▶ Two approaches (do both, Macro first)
 1. Macro View
 - Determine market potential
 2. Detailed View
 - Estimate price will sell product for, estimate number of products will sell each month. Estimate how quickly can ramp up.



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Macro View

- ▶ Market Potential
 - What is current size of market in \$
 - What is expected growth
 - Assume reasonable penetration of market over time



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Market Potential – Example one

- ▶ The market is hospitals with 3-5 operating rooms.
- ▶ In US there are 100,000 hospitals meeting this criteria.
- ▶ If 10% of this market purchases and our product sells for \$ 35,000 = \$350 MILLION market potential
- ▶ If 100% then 3.5 billion



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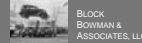
Market Potential – Example two

- ▶ In US alone, purchases of
- ▶ We expect to be able to install 2 per month for first 6 months, 4 per month for next 6 months = 36 installations first year. At \$35,000 per installation and first year license fee and then 15% maintenance and upgrade fee annually thereafter (= 5,250 per year or \$437.50 per month)
- ▶ Check to see what % of market this is – if find unit projections are 10% of market in first year, too aggressive. 5% or less is best.



Market Potential – Example three

- ▶ Currently, over 1 billion is spent annually in US on new EEG equipment.
- ▶ Our product enables more sensitive measurements of brain activity and is expected to eventually replace at least 2% of the market in the first two years.
- ▶ So—20 MM at end of 2nd or third year.
- ▶ Then decide reasonable ramp up – and how many units this means, is it feasible, how much will cost etc.



Next Step in Projections

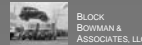
- ▶ Estimate COGS (direct costs)
- ▶ What is included depends on the product/industry.
 - Direct Labor, raw materials, etc.
- ▶ First approach – find other comparable public firms and see what their COGS is as a % of revenue.



▶ Medical Device

Cabot	Revenue	27 Million
	COGS	5.47 Million
		20.3 %
Circon	Revenue	180 Million
	COGS	29.3 Million
		16.3 %
Olthy	Revenue	46 Million
	COGS	9.8 Million
		21.3 %

- ▶ Estimate 18% decrease as volume increases.
- ▶ Same with marketing and General and Admin expenses

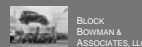


- ▶ Revenue _____
- ▶ Less COGS _____
- ▶ Gross profit _____
- ▶ General and Admin _____
- ▶ Other Expenses _____
- ▶ Operating Income: xxxxxxxxxxxxxxxxxxxxxx
- ▶ Then need to ultimately turn it into a cashflow – less capital expenditures, less increase in inventory etc.



EBIT or EBITDA

- ▶ Used as a rough approx for cashflow = earnings before interest and taxes or Earnings before interest, tax, deprec and amort.
- ▶ Take operating income, add back interest, taxes, deprec, amort.
- ▶ Will have lecture on details of estimating cashflow (or half lecture)



How Much \$ Needed- Alternative Approach

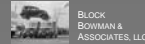
1. Look at big ticket items – marketing and sales plan \$2 mill to implement
 2. Hire CFO 150,000
 3. Produce product for 1st year 350,000
 4. Patent filings 100,000
 5. Staffing increases 250,000
- ▶ \$4 mill. (you always underestimate so round way up)



Investment Banking

- ▶ Three operating arms:
- Corporate Finance
 - Mergers
 - Sometimes Venture Capital

Support – Research and Trading



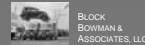
Corporate Finance

- ▶ Taking Companies Public
- IPO
 - Secondary Offerings
- ▶ Private Placements
- ▶ Advisory Role



Support for Corporate Finance

- ▶ Research Analysts
- ▶ Traders



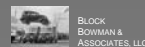
Investment Banking

- ▶ Mergers & Acquisitions – transaction oriented



Venture Capital and Equity Groups

- ▶ Specialized by industry and size of transaction
- ▶ Large funds
- ▶ Out in 4-5 years.



Begin Project (Comprehensive Project)

- ▶ Define market size
- ▶ Choose idea
 - Software program for college students
 - Software to manage email archives
 - Your idea



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