

**Entrepreneurship Essentials**  
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**Module - 10**  
**Lecture – 49**  
**Funding New Venture – IV**

Welcome. Today's topic is angel investor or angel Funding Venture capitalist or VCs or venture capital fund and then how to structure a deal.

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**Business Angels or Angel Investors: Who Are Angel Investors?**

- An angel investor is an individual who has surplus fund and provides capital to an early stage startup in exchange for part ownership. Invests personal capital in start-ups
- Angels usually support at the early stage when the risk of failure is higher compared to more matured stage.
- Usually they are experienced in particular domain or new venture creation in general and have a good perspective of the likely success of a venture.
- They take calculated risks, mentor the ventures closely, take all necessary actions for it to succeed.

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So, let us move forward. Business angels or angel investors, these are people they may be individuals or they may also work in consortium like say two, three, four five guys working together. They individual; they have they are fairly rich people meaning that they have made capital either through some startup or they are retired executives maybe from some professionally managed company. So, they may have something like 50 crore to 100 crore rupees in their bank and now they would like to get the kick or the excitement of a startup.

They do not want to start by themselves, but then they want to put the capital in some startups where they can use their own expertise and monitor or mentor, they startups to success and then they create more wealth for themselves create wealth for a start up and then they get the charm of or say excitement of winning in a in an enterprise. So, usually they are experienced people, they have domain knowledge and then they are eager to take calculated risk. They

have they had always been active. Now they want to active even after earning lot of money so, they kind of mentor startups.

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**Who Are Angel Investors?**

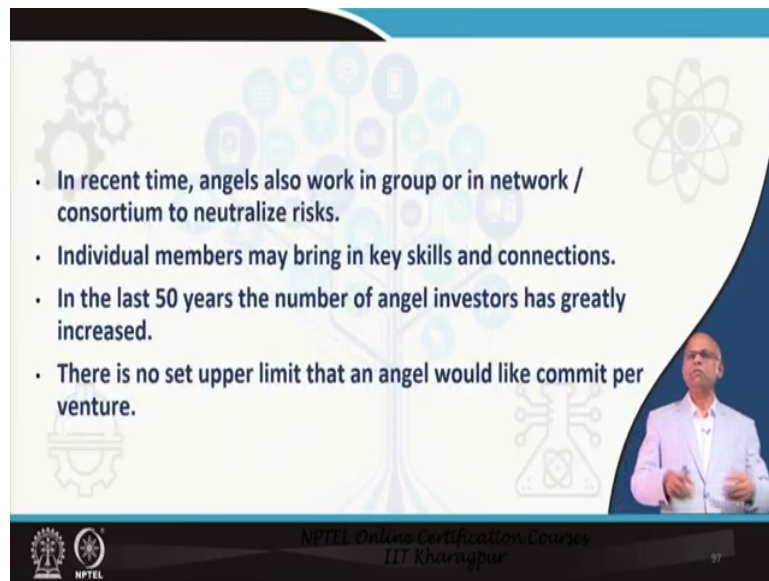
- **Business Angels are individuals, invest personal capital in start-ups**
- **The prototypical business angel ...**  
is in the middle age; has high income and wealth; is well-educated;  
has succeeded as an entrepreneur;  
is interested in the start-up process.
- **Business angels are valuable because of their willingness to make relatively small investments, giving equity funding to a start-up needing about ₹ 2.00 million to ₹ 10.00 million.**
- **Venture capitalists usually fund above ₹ 50.00 million per unit**

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Angels are individuals as I said. The prototypical business angel is in the middle age maybe they have because they have made money has high income and wealth is well educated has succeeded in an as an entrepreneur is interested in the start of journey or take that excitement ups and downs and all that.

Normally they invest something like 2 million rupees, 20 lakh rupees to 10 million, 1 crore.

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- In recent time, angels also work in group or in network / consortium to neutralize risks.
- Individual members may bring in key skills and connections.
- In the last 50 years the number of angel investors has greatly increased.
- There is no set upper limit that an angel would like commit per venture.

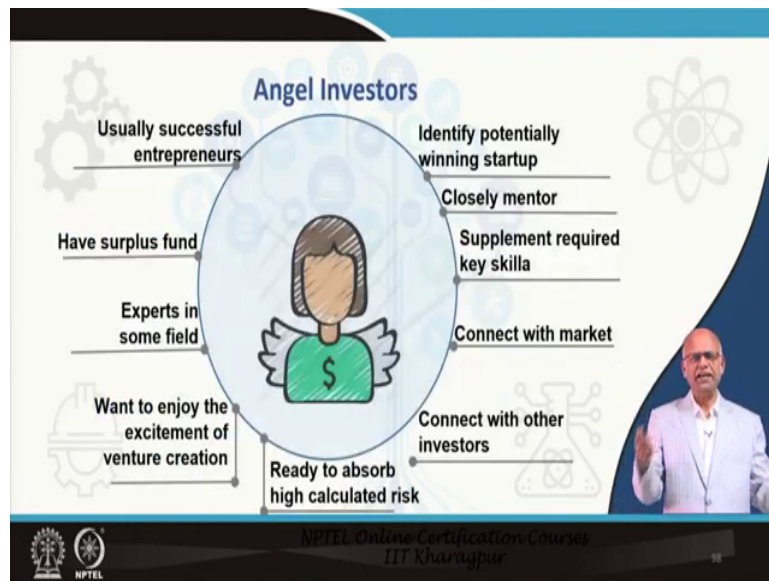
At the bottom of the slide, there are logos for NPTEL and IIT Kharagpur, along with the text "NPTEL Online Certification Courses IIT Kharagpur".

Whereas VC is normally invest much more will come to VC later. In recent time, angels also working group as I said. Individual members may bring in key skills and connection. Suppose one particular angel has identified one potentially winning startup position, then maybe he is expert in he or she is expert in particular domain and the angel wants another person with some other domain knowledge which is which is to be integrated here.

So, this particular angel number one may invite another angel or a group of angel to go ahead.

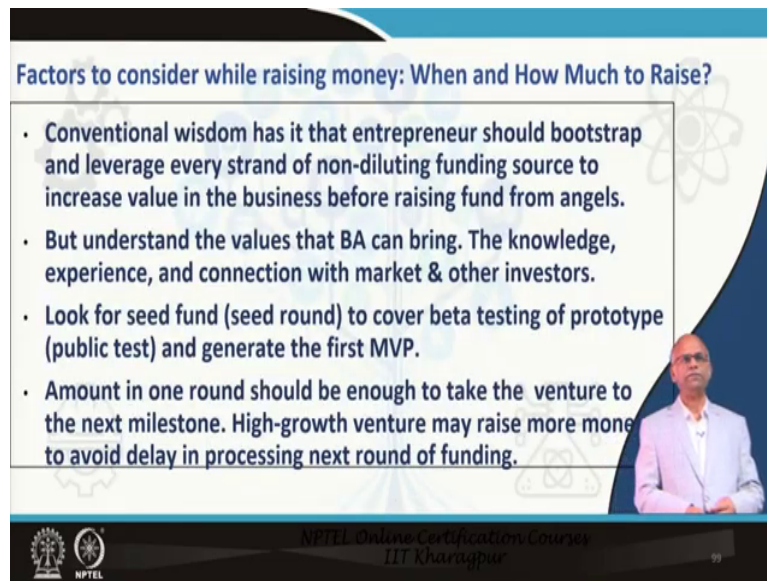


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So, here is everything put in one place. So, usually they are successful. Entrepreneurs or executives from big companies, they meant the startup closely because it is their hard earned money and then they want to make sure that the budding entrepreneurs do not make mistakes. So, they will be closely associated with them. They try to connect them with the market, with more investors whatever the entrepreneurs need, they will try to address that.

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**Factors to consider while raising money: When and How Much to Raise?**

- Conventional wisdom has it that entrepreneur should bootstrap and leverage every strand of non-diluting funding source to increase value in the business before raising fund from angels.
- But understand the values that BA can bring. The knowledge, experience, and connection with market & other investors.
- Look for seed fund (seed round) to cover beta testing of prototype (public test) and generate the first MVP.
- Amount in one round should be enough to take the venture to the next milestone. High-growth venture may raise more money to avoid delay in processing next round of funding.

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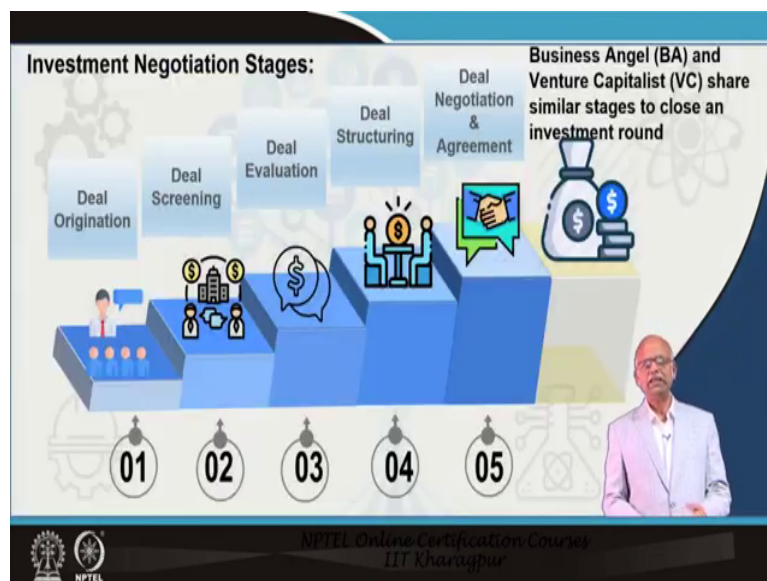
Now, this is fine angels are fine, but then when to how much to raise money meaning you have to be judicious as to what to ask how much to ask. We have been discussing that throughout the throughout this week, but some more information. Conventional wisdom has it that entrepreneur should bootstrap as much as possible as long as possible. So, that they create more value and then they are in a kind of a negotiating position before business angels and they can get more money there will be more, they will have more promising stories and then there their dilution will be less etcetera.

But at the same time one has to see what kind of information, what kind of expertise that business angel brings on the table. They brings experience, they brings connectivity, they brings you know networking with all investors market whatnot.

So, if you are connected with some angel, then it becomes almost like you are a start up becomes their baby. So, your success is their success. So, you have almost like a co-founder with lot of a stake in your business. So, at you have to make a compromise between the two when to approach and how much money to ask for. Money should be good enough just good enough for you to move to the next milestone whatever milestone. You define not more not less.

Look for seed fund to cover beta testing prototype like do not go to business angel immediately. Just I will tried to make a minimum viable prototype using bootstrapping or maybe friends and relatives that is it.

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Now, here I show you the different stages of a negotiation with either a business angel or venture capitalist. I will define the venture capitalist later. But what are the steps? There is a

systematic approach to negotiating with angels and VCs. Some angels may not do much of the due diligence or much of the processes, but then it is academically we have to be thorough about the steps and VCs actually are very meticulous. There they will follow all these steps very meticulously. In fact, per proposal their cost it itself will be something like 50000 dollar that makes something like 35 lakh rupees.

So, we have to be we have to be conversant about that ok. So, it starts with deal origination means you pitch before number of angels and then one particular angels find finds that your proposition is promising kind of it is aligned with their expertise, their future objectives or maybe that they already have funded two, three, four, five are the startups in the same domain.

So, they can copy paste some of the knowledge from there to your enterprise. So, they can they do not have to study a lot, they do not have to have to borrow knowledge from anybody else because some startups are some startups among their portfolio of startups may be able to help you or maybe they connect together maybe you are all working at a back end, they are working at the front end; connectivity will be good. So, they will decide fine let me make some few other assessment about your exact status and then make a decision that is when deal is originated.

Then deal is screening, they start doing the due diligence. The screen your true status; your balance sheet profit loss account that may not actually reflect the real story. So, they will put some engage some auditors if necessary some kind of even intelligence guys. So, that they get to know whether there are hidden information because there is a tendency of entrepreneurs to hide informations from investors; nobody can be blamed for that. Because everybody wants to put their best face forward whereas, this is not good if investors come to know that you have suppressed information. They might very well decline to move forward because they want honest people they want to work with honest people.

So, you have to be very clear do not suppress anything, it is going to come out to today or tomorrow and you will be caught. Then deal evaluation, once they get it they start doing the math they evaluate, then once they decide that yes this is a company that we are going to fund

final. So, they will be negotiating a deal a structure of the deal means how much equity, how much percentage holding whether it is going to be preference capital or it is going to be equity capital or debt funding all those will be discussed with the entrepreneurs. Finally, if both parties are on the same page, there will be an agreement.

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**Common Reasons for Rejection of Investment Proposal by Angel**

- Business located outside the geographical reach of BA investors.
- Stage and type of venture: for example, long pre-revenue and product development phase.
- Unattractive sector or market: for example, low margins and high volatility (retail, hotels, restaurants, property); highly competitive or high technical risks or both (e.g. consumer goods, telecom, clean tech, drug development, computer hardware).

The slide features a presenter in a light blue suit on the right side. The background includes faint icons of a hard hat, a person, and a circuit board. The footer contains the NPTEL logo, the text 'NPTEL Online Certification Courses IIT Kharagpur', and the number '101'.

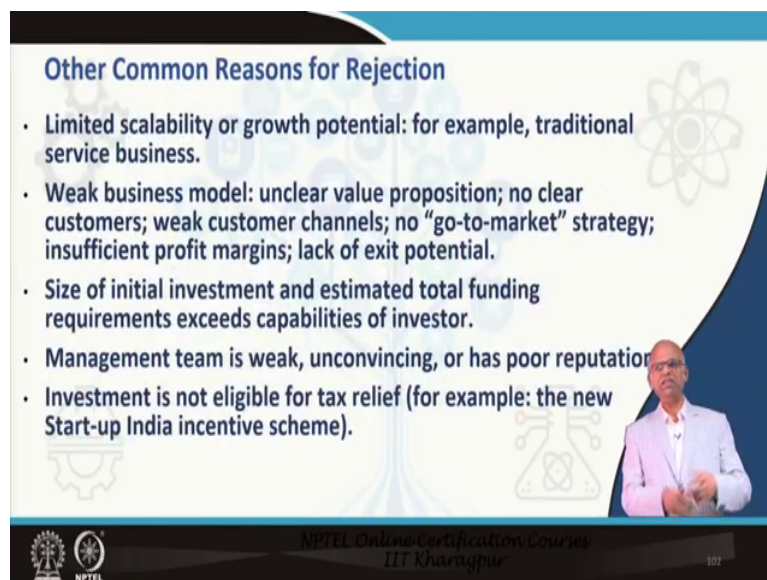
So, they will give the money and then you move forward. Why do they reject normally? The reject, because angels rich is kind of limited, they do not want to invest anywhere and everywhere; they want to keep an eye on the company. So, they will be preferring that you are geographically located in the city or nearby. So, that you can you know drive 1 hour, 2 hours and then reach there and then have a fair idea as to where you are stage.

And type of venture for example, long pre revenue and product development phase. If you are kind of at a play at a at a stage when you need a long time to reach to the next milestone, they

are kind of not so much motivated. Then sector wise also they have preference like somebody retired from say a software company may not like to like to mentor or fund a manufacturing company. He or she may not have much idea about that number 1. Number 2, there are sectors which is not so not a scalable or not promising to grow faster etcetera.

So, those other like say retail requires huge capital, it may not be the cup of tea for it for an angel the hotels. They grow slow restaurants property these are high risk and not so much growing. Highly competitive and high technical technically risk or maybe both like consumer goes telecom clean tech, drug development, computer hardware. Computer hardware many new technology that you want to bring require request so much time request money, but request so much time that the by the time you come up with a new product, you will find that the market has gone ahead far ahead of you. So, it is only big companies who can afford to do this.

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**Other Common Reasons for Rejection**

- Limited scalability or growth potential: for example, traditional service business.
- Weak business model: unclear value proposition; no clear customers; weak customer channels; no "go-to-market" strategy; insufficient profit margins; lack of exit potential.
- Size of initial investment and estimated total funding requirements exceeds capabilities of investor.
- Management team is weak, unconvincing, or has poor reputation.
- Investment is not eligible for tax relief (for example: the new Start-up India incentive scheme).

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107

So, most of the angels will be you know refraining from even trying to invest there. Other reasons limited scalability, limited growth potential. For example traditional service businesses where growth potential is less; weak business model weak value proposition. Then maybe you do not have a go to market strategy, go to market strategy means how you are going to acquire customer, retain them, then grow the customer base. So, that gradually you grow to a to you sustain the growth potential. Size of initial investment in the size require something like 10 million dollar, angels will not be interested.

They may be interested to you know bring in more angels and invest provided. The business model is so attractive that they are they are kind of it becomes so, means they are enticed into investing in that. Management team is weak, then they are not convinced that management has the vision, the capability to strategize the required strategies for acquiring customers or many other things has poor reputation perhaps they already have defaulted somewhere in whatever things.

So, if they have bad reputation, nobody wants to touch them because anybody with a with some kind of a fraudulent activity people think that they are genetically fraud. They will not try to touch them again. It is almost like established that those who do fraud, they are kind of genetically inclined towards that they will always try for shortcut and then try they will always try to defraud others.

So, stay away from them. Just try to understand people and then stay away from them. Investment is not eligible for tax relief there are some other issues.

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**De-Risking The Deal!**  
Preserve equity by de-risking the deal

- You only raise enough money to get to the next proof point.
- **At early stage:** technology & team risk.
- **As you go-to-market:** execution risk, market acceptance risk, team
- **Growth phase:** risk associated with cost of manufacturing, marketing channel, skilled manpower, adequate finance, competition.

The slide features a graph with a vertical axis labeled 'RISK' and 'Valuation', and a horizontal axis labeled 'Time'. A green line representing 'Valuation' starts at the origin and trends upwards. A red line representing 'Risk perception' starts high and trends downwards. The background includes images of a hand holding a seedling, a growing plant, and a basket of tomatoes. A small inset photo of a man in a suit is visible on the right side of the slide.

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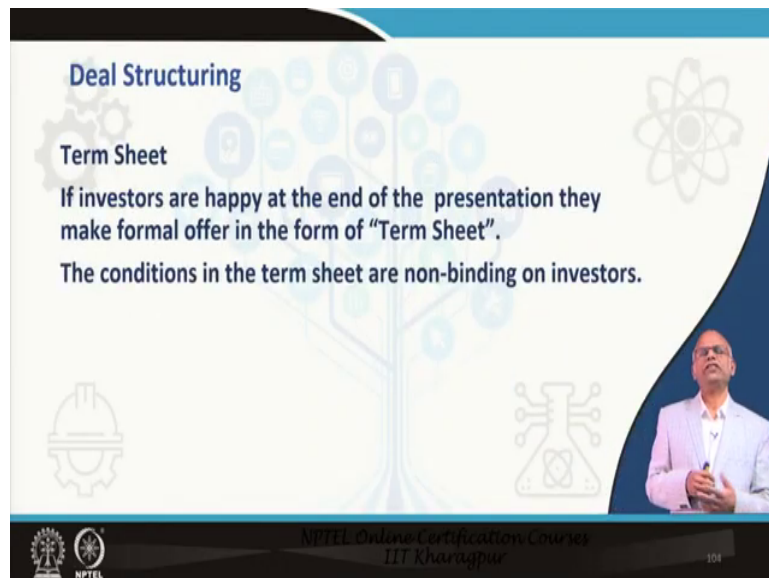
You know how to de risk a deal. You can do risk moving forward. See that is that is what the topic all through the discussion about funding new ventures had been like you should always try to make progress by making progress.

You are actually reducing the risk; the green line is valuation, the red line is risk perception. So, as you move forward, the x axis is the time. So, as you move forward, you are actually eliminating the risk because your product is now at a matured stage. It is validated then some customers have accepted something like that. So, you are de risking because now investors will think that risk is less because your product is already accepted by the market, you have acquired something like 100 customers. So, customers are going to grow if they have hand hold then journey will be smoother so, that is what is de risking.



So, as you move forward, you try to means you try to move forward with your own money through bootstrapping or taking less amount of money and move forward by de risking deal structuring.

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**Deal Structuring**

**Term Sheet**

If investors are happy at the end of the presentation they make formal offer in the form of "Term Sheet".

The conditions in the term sheet are non-binding on investors.

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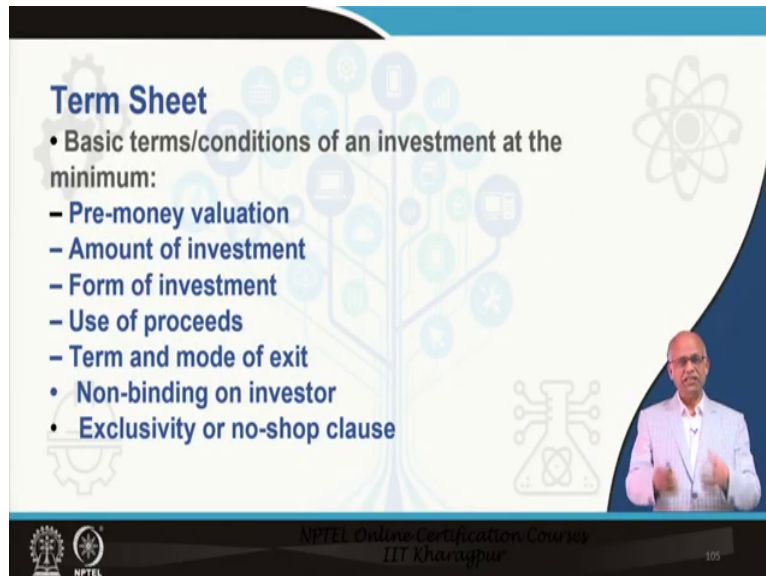
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104

How to structure a deal? Normally before deal structure, there will be a term sheet meaning suppose an angel agrees to fund. So, they will say there ok. I will prepare a term sheet and then you sign the term sheet. What are the term sheet? Term sheet contains all the terms and conditions including the period that is the term of the of the agreement. Suppose they say that within 6 months we are going to finally, sign on the dotted line and give you the money. So, that is the term.

Now term sheet includes all the terms and conditions as well. The conditions in the term sheets are not so binding meaning is not as so much of a legal document, but then is a starting point.

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**Term Sheet**

- Basic terms/conditions of an investment at the minimum:
  - Pre-money valuation
  - Amount of investment
  - Form of investment
  - Use of proceeds
  - Term and mode of exit
- Non-binding on investor
- Exclusivity or no-shop clause

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105

The basic terms and conditions of an investment at the very minimum is pre money valuation. Pre money valuation is before the angel puts money into your enterprise, they are going to make a valuation. What is the value of your company? Maybe your company does not have a product, does not have anything, but then you have an idea at least. So, maybe the idea has value.

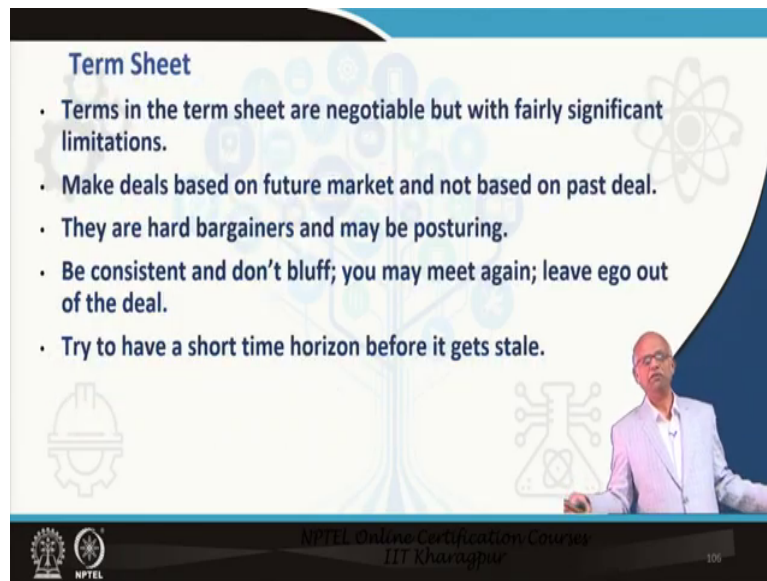
So, they are going to make a valuation of than whether it is 5 lakh rupees or 50 lakh rupees or a billion dollar that will depend on the potential of the idea that is pre money valuation. Then amount of how much money they are going to invest, how much money you need, how much

money they are going to give form of investment. Is it going to be equity investment, debt investment, preference capital convertible debt; something like that use of process.

How you are going to use that money? Why do you need the money? Where are you going to deploy and then what is the outcome of such deployment? That is also will that will also be written there if you do something other than that then that will be a violation of the terms of the term sheet. Then mode of exit mean term and the mode of exit term means period of this investment. The investment is made how long the investor should remain invested and then when are they going to exit, how are they going to exit, is it going to be an IPO or is it going to be a takeover by some other company or is it going to be some strategic investors buying out the investor whatever.

Nonbinding on investor invest this term sheet is absolutely non-binding on the part of the investor meaning that they can violate something and nothing will happen exclusivity and no shop clause. Meaning that as long as you are bargaining with one particular angel, you must not go to another angel as a with a simultaneous negotiation. So, if they come to know that you are talking to another angel without telling them that we are actually trying different places, then they are going to call it off and then go away. Even they may even inform the other angel that look this guy was talking to us and there is a no shop clause, but still they are talking to you; that means, is not an honest guy. So, even that angel will go away from you.

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**Term Sheet**

- Terms in the term sheet are negotiable but with fairly significant limitations.
- Make deals based on future market and not based on past deal.
- They are hard bargainers and may be posturing.
- Be consistent and don't bluff; you may meet again; leave ego out of the deal.
- Try to have a short time horizon before it gets stale.

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Terms in the term sheet are kind of negotiable; obviously. So, there are limitation how much you can negotiate. Make deal based on future market and not based on past deal. If you if you tell them that look so and so got 10 lakh rupees by diluting only 2 percent so, I was so, on that does not actually happen because you need to look at your strengths and weaknesses based on that you can make a deal. The hard bargainer remember angels are hard bargainer. They may be posturing, they may say that you have nothing and I do not think that anybody will invest even I am not going to invest.

But you know if you if you give me 50 percent, I can give something like 10 lakhs something like that. These are all posturing maybe they are already attracted with the business model and they would like to invest. But as a chief of for the bargaining, they will tell all negative or

pessimistic things. So, they may maybe posturing be consistent do not bluff, do not bluff, do not bluff.

Because you are going to meet again and know that this market is absolutely transparent. You bluff to a to an angel, he is going to broadcast the information to all the angels and nobody will touch you and put your ego out of the deal. Suppose he is that was the angel says that your technology is rubbish all crap, do not get excited, do not get annoyed. You just remain patience; patience only help, annoyance does not pay you a single paisa.

Try to have a short time horizon before it gets stale meaning that do not ask for one year time to you know come up with information. Suppose they want some information, give it immediately and close the deal within the shortest possible time.

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**Due Diligence**

- You, your team and your company are under a microscope.
- Legal, financial and strategic review of organizational structure, history, contractual relationships and documents.
- Will be tedious, frustrating, time consuming and costly.
- Key to success: preparation and cooperation.

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Now, when they agree that I am kind of impressed with your business model, now let us see let us move forward the first thing they would like to do is due diligence due diligence. Meaning they want to enquire deeper inside your company, they want to know the truth of the company because all information that you provide may be biased, may be may not be right true; maybe there are some assumptions that you are not telling them most importantly there may be some creditors that you have kind of eliminated from your balance sheet. Now the moment they will pay your money, the creditors will go to the court and file a case and eventually money has to be given to them.

So, they would like to know whether there are there are unknown creditors, there are unknown liabilities or have you have you put some money in some other company, companies where you are trying to actually make some kind of a rainy day saving somewhere. If that is the case, you should tell them clearly.

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**Due Diligence – Art and Science**

**The “Art”**

- What to ask, how to ask, when to ask.
- DD team is on a “search and destroy” mission.
  - Search for problems.
  - Destroy (eliminate) concerns or fairly allocate.

**The “Science”**

- Comprehensive list of questions to ask.
- System to organize and analyze data provided.
- Quantitative analysis of risks uncovered.

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The art and science of due diligence; what to ask, how to ask, when to ask? The due diligence team is in a search and destroy mission. I am talking this from the angels point of view. They are in a search and destroy mission in the sense that they want to search a bulleted list of items though. Those are negative items and they want to destroy those items meaning that they want to search and make them clear that this doubt is clear. Destroyed meaning that there is no question of doubting on this account.

So, they are in a mission to search a listed items that these are traditionally the places where people make all those kinds of mistakes. So, they want to eliminate them. Destroy eliminate concerns or fairly allocate the fairly allocate. The science comprehensive list of questions to ask like what are the what they have a questionnaire, they will be asking you then the system

to organize and analyze data that you provide. So, they will be kind of doing some even statistical analysis, quantitative analysis to understand where you actually stand.

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**What are They Looking for?**

- Overdue tax liabilities.
- Inadequate systems.
- Related-party transactions.
- Unhealthy reliance on customers/suppliers.
- Overdue accounts or unrecorded liabilities.
- Immediate need for major expenditures.

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109

What are they looking for? They are looking for overdue, tax liability, inadequate system, related party transaction. Meaning that suppose your wife has given a car to you on rent so, you are actually giving the money company money to your wife; is it the case; that means, there is a related party transaction meaning you are actually siphoning out money and giving it to somebody related to you. So, you are actually taking money away; unhealthy reliance on customer suppliers overdue account etcetera.



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**Define Venture Capitalist and Venture Capital**

- A venture capitalist (VC) is a private equity investor who pool funds from various investors and provides capital to companies exhibiting high growth potential in exchange for an equity stake.
- Venture capital is a form of risk capital that fund startup companies and small businesses that are believed to have long-term growth potential or companies that have grown quickly and appear poised to continue to expand.
- Venture capital generally comes from well-off investors, investment banks and any other financial institutions.

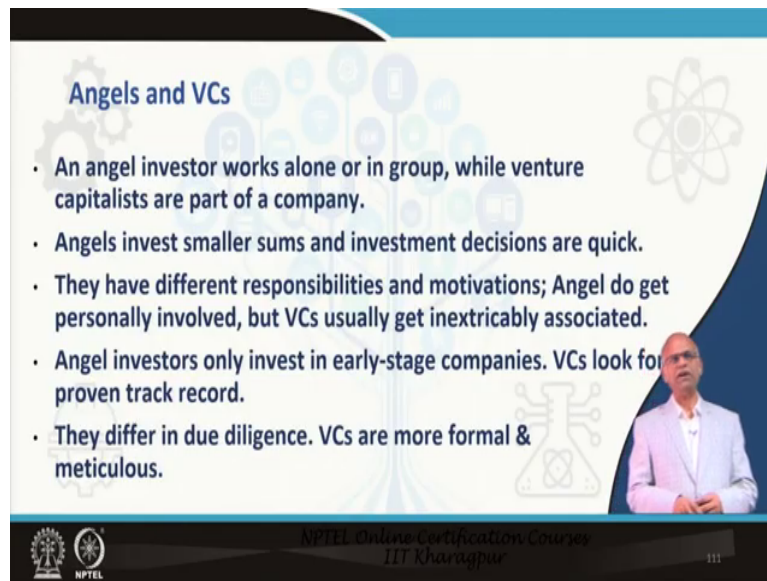
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110

Definition of a venture capitalist; venture capitalist and venture capital: the money that venture capital is give is venture capital. Now a venture capitalist is a private equity investor who pool funds from various investors and provides capital to companies exhibiting high growth potential in excess for an equity stake. It may be a high growth potential or maybe you have already established growth means you have already achieved growth and there is a potential that you will continue to grow in future only then venture capitalist comes here and invest.

Venture capital generally comes from well off investors investment banks and any other financial institutions in India say to be has promoted has been funding so many venture capitalist. They are a state government venture capitalist. There are private venture capitalist should be is funding to many.

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**Angels and VCs**

- An angel investor works alone or in group, while venture capitalists are part of a company.
- Angels invest smaller sums and investment decisions are quick.
- They have different responsibilities and motivations; Angel do get personally involved, but VCs usually get inextricably associated.
- Angel investors only invest in early-stage companies. VCs look for proven track record.
- They differ in due diligence. VCs are more formal & meticulous.

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111

Angels and VCs: What is the difference? An angel investor works alone or in a group while venture capitalists part of a company like they invest in your company, they will place a person in your board of directors. So, they become part of your company and then they become part of your a strategy making decision making process angel investor smaller sums where whereas, venture capitalists invest a large sums. Typically it will be something like say more than 10 million dollar.

They have different responsibilities and motivation. Angels has a motivation to be part of the company like he will sit with you and all that, but then VCs are normally inextricably associated. They are almost part of the company. Angel investors only invest in early stage like they have slightly more risk appetite because if they invest too early, then they can expect more equity from the company. So, eventually their value will expand many times more than

VCs money because VC comes at a later stage when the valuation is high the different due diligence.

VCs are very formal, they are they do due diligence very formally sometimes they spend as I said 50000 dollar to do all the studies. So, eventually they will give millions of dollars, but then remember VC is going to charge you that 50000. If they spend that money whatever they spend for due diligence, they are going to ask you to pay that.

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The slide is titled "Preference Shares" and features five bullet points in dark blue boxes with white text. A presenter in a white suit is visible in the bottom right corner of the slide. The slide also includes logos for NPTEL and IIT Kharagpur at the bottom.

- Preference shares represents quasi equity capital.
- It has features of both equity and debt.
- It does not give voting right to the holders.
- Fixed rate of dividend, but are performance-driven.
- It carries preferential rights over ordinary equity shares in sharing of profits and also claims over assets of the firm.

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Now, mostly VCs and angels will invest in preference shares. So, you must know what are the types of preference shares. They are in between debt and equity. So, they called quasi equity quasi equity. It has features for both equity and debt it does not give voting right. If someone invest in preference capital, he or she does not get voting rights because it is not equity.

They get fixed rate of dividend and this is performance driven because if you do not make profit, you do not give dividend in that year. It carries forward; it carries preferential rights over ordinary equity share holder in case there is a bankruptcy or something, they get money before equity share holder. So, they are actually senior in rank.

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**Pre-money And Post-Money Valuation**

Pre-Money	Angel-1 brings in	Post-Money value
₹5,00,000	₹10,00,000	₹15,00,000

Founders' holding:  $5,00,000/15,00,000 = 33.33\%$   
Investor's holding:  $10,00,000/15,00,000 = 66.67\%$

Pre-Money	Angel-2 brings in	Post-Money value
₹100,00,000	₹500,00,000	₹1500,00,000

Percentage holding is based on negotiation. It is not calculated based on investment committed  
Founder & Angel-1= 70%  
Investor's holding: 30%

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Now, I talked about a pre money valuation at the beginning of this session . What is pre money and post money valuation? Suppose you have a starter, we just have an idea and almost like some earliest product. Now you approach to an angel. He comes here, looks at it and say what this is hardly anything. I will value your business at this point of time at 5 lakh rupees. So, he said the angel says that I can give you 10 lakh rupees, but your company is valued at 5 lakh.

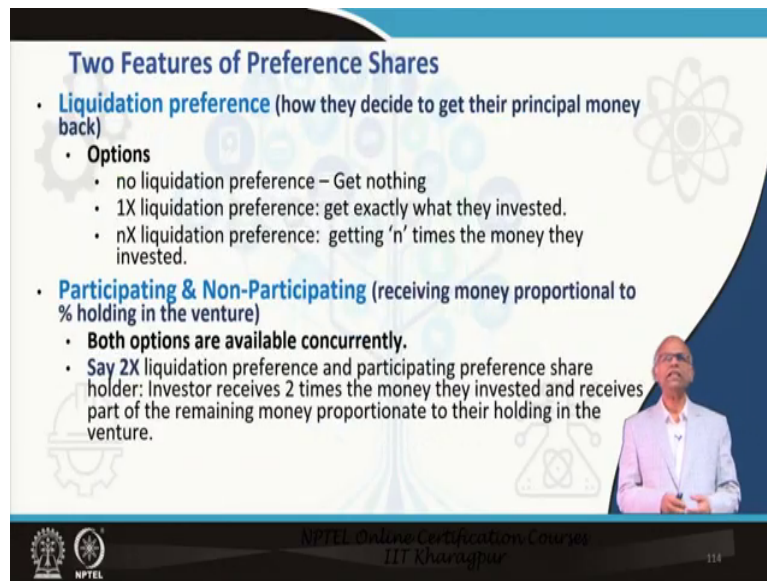
So, when the angel says your company value is only 5 lakh and that means, that is the pre money value. Now, but suppose the angel brings 10 lakh rupees so, post money value is 5 lakh rupees that has been valued before giving the money and he brought or she brought angel brought 10 lakh rupees. These are cash. So, 5 lakh plus 10 lakh that becomes post money valuation. And what is the holding? Pre money you were holding only 5 lakh, post money the angel holds 10 lakh. So, that you are holding is the total value is 15 lakh.

So, you are holding is 5 lakh divided by 15 lakh. So, it is 33 percent investors holding is 10 lakh divided by 15 lakh. So, it is 66 percent. Now suppose after a while you invite another angel, now angel to comes here and values your company at 1 crore rupees. Now when angel 2 values your company at 1 crore rupees that is the pre money value now.

And angel promises to bring 5 crore rupees. So, 1 crore rupees plus 5 crore rupees becomes this is 5 crore and 1 crore become 6 crore; it should not be 15 crore, 6 crore rupees. So, 6 crore rupees is the post money value. So, accordingly you will estimate the percentage meaning 1 crore divided by 6 crore and 5 crore divided by 6 crore, 5 crore divided a six crore will be angels investors. actually I wanted to put pre money value at 10 crores. So, there you can put a 0 over there.

So, pre money value is 10 crore, then angel brings 5 crore. So, it becomes 15 crore. So, you are holding your as well as the angel once combined holding becomes 10 crore divided by 15 crore which is 66 percent. And angels two angels 2 is holding becomes 5 crore divided by 15 crore which is like 33.33 percent.

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**Two Features of Preference Shares**

- **Liquidation preference** (how they decide to get their principal money back)
  - **Options**
    - no liquidation preference – Get nothing
    - 1X liquidation preference: get exactly what they invested.
    - nX liquidation preference: getting 'n' times the money they invested.
- **Participating & Non-Participating** (receiving money proportional to % holding in the venture)
  - **Both options are available concurrently.**
  - **Say 2X liquidation preference and participating preference share holder:** Investor receives 2 times the money they invested and receives part of the remaining money proportionate to their holding in the venture.

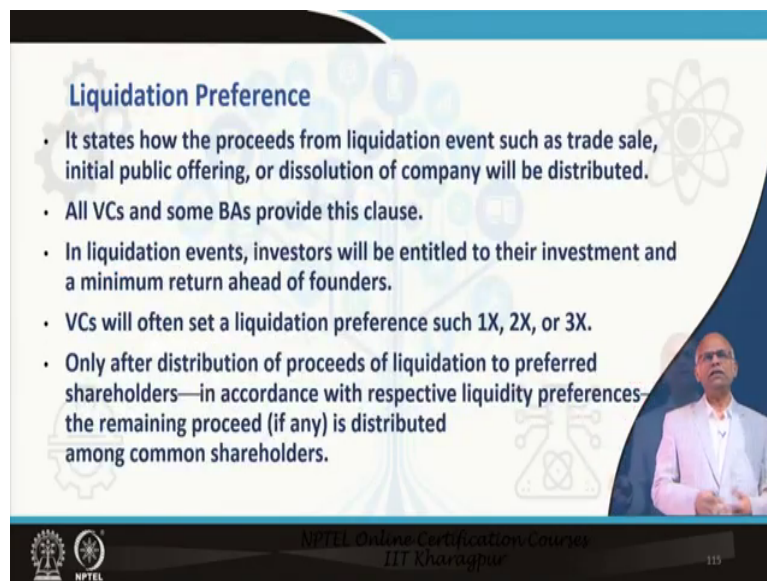
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Now, two features of preference share; one is liquidation preference what that is why it is called preference share another is participating and non participating. Liquidation preference means at the time of liquidation where what kind of return that they want on their investment. If there is no liquidation preference, they are not asking for a certain return at the time of liquidation. They will work they will just take the money as per they are holding in the company. Whereas, if they say that we want 1 X liquidation preference; that means, they will at the time of liquidation event like.

Suppose your company is taken over by another company for certain amount of money. At the when you will share this money proceeds, they will say give me my 1X money fast, then whatever is remaining we will share it proportionately something like that. If it is 2 x return, they want initially 2 times their money, 3 times their money, 4 times, n times their money.

I will show an example to drive of this point. Participating means participating means they are also participating in equity. Suppose at the time of investment, they say that I want 20 percent of the equity, but I will be investing in preference share. And I have 1X liquidation preference; that means, at the time of liquidation, they take one x first. Then whatever remains, they take 20 percent of that because they hold 20 percent of the company.

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**Liquidation Preference**

- It states how the proceeds from liquidation event such as trade sale, initial public offering, or dissolution of company will be distributed.
- All VCs and some BAs provide this clause.
- In liquidation events, investors will be entitled to their investment and a minimum return ahead of founders.
- VCs will often set a liquidation preference such 1X, 2X, or 3X.
- Only after distribution of proceeds of liquidation to preferred shareholders—in accordance with respective liquidity preferences—the remaining proceed (if any) is distributed among common shareholders.

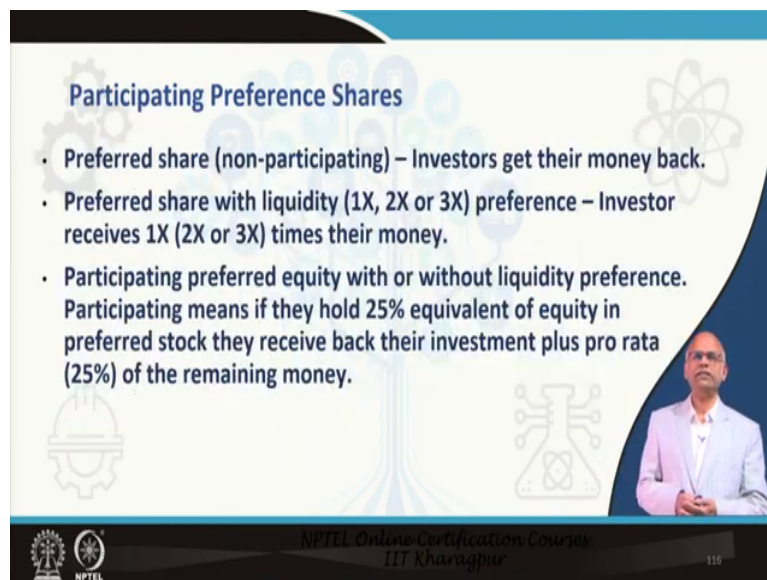
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115

Now, liquidation preference some more explanation: It is just how the proceeds from liquidation events as a straight sells or initial public offering or dissolution of the company will be distributed. All VCs and some venture engines, business engines provide this loss; obviously, otherwise there will be no clarity as to how to distribute the money. In liquidation even investors will be entitled to their investment and a minimum return ahead of founders.

Before founder founders get anything, they will get their money for sure. Now VCs will often set in liquidation preference of 1X, 2X, 3X etcetera.

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**Participating Preference Shares**

- Preferred share (non-participating) – Investors get their money back.
- Preferred share with liquidity (1X, 2X or 3X) preference – Investor receives 1X (2X or 3X) times their money.
- Participating preferred equity with or without liquidity preference. Participating means if they hold 25% equivalent of equity in preferred stock they receive back their investment plus pro rata (25%) of the remaining money.

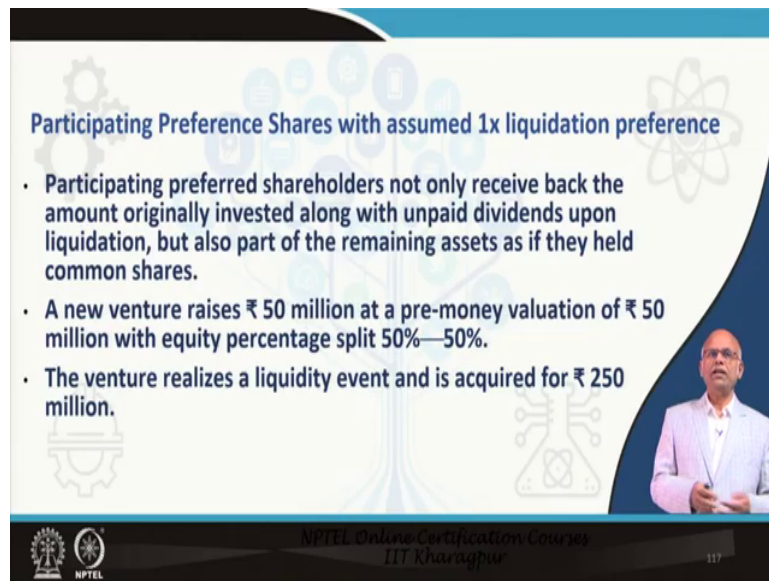
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115

Let us move forward and see with an example. If it is participating, then they participate in equity they say that I have 20 percent equity, 30 percent equity, 50 percent of whatever they have.



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**Participating Preference Shares with assumed 1x liquidation preference**

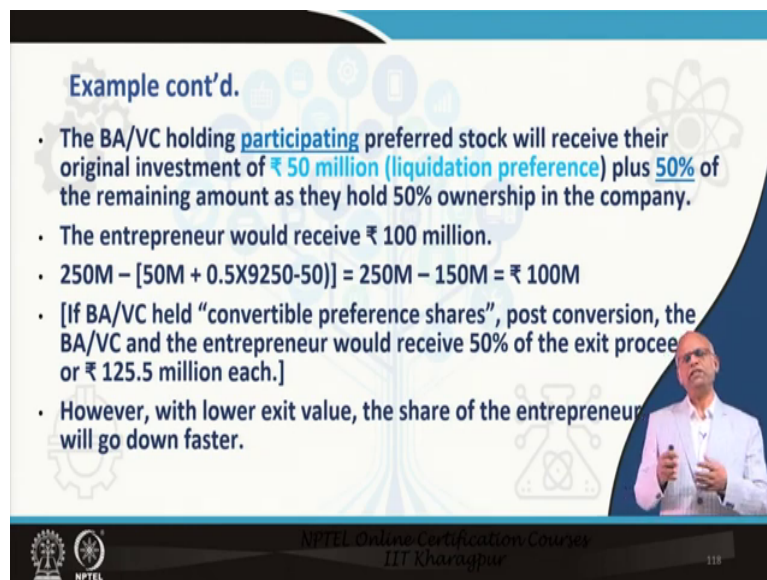
- Participating preferred shareholders not only receive back the amount originally invested along with unpaid dividends upon liquidation, but also part of the remaining assets as if they held common shares.
- A new venture raises ₹ 50 million at a pre-money valuation of ₹ 50 million with equity percentage split 50%—50%.
- The venture realizes a liquidity event and is acquired for ₹ 250 million.

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117

Now, participating preference shareholder not only receive back the original amount that they invested that is participating and as also they get some percentage of the proceeds. This is an example.

(Refer Slide Time: 30:24)



**Example cont'd.**

- The BA/VC holding **participating** preferred stock will receive their original investment of ₹ 50 million (**liquidation preference**) plus **50%** of the remaining amount as they hold 50% ownership in the company.
- The entrepreneur would receive ₹ 100 million.
- $250M - [50M + 0.5 \times (250 - 50)] = 250M - 150M = ₹ 100M$
- [If BA/VC held “convertible preference shares”, post conversion, the BA/VC and the entrepreneur would receive 50% of the exit proceeds or ₹ 125.5 million each.]
- However, with lower exit value, the share of the entrepreneur will go down faster.

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Suppose the BA or VC; BA means business and sell or venture capitalists holding participating preference a stock. They will receive their original investment. Suppose there should be an example here. Yes, a new venture raises 50 million at a pre money valuation of 50 million, pre money value 50 million.

And then they bring 50 million; that means, they get 50 percent of the equity founders remain with 50 percent. So, it is a 50-50 distribution. The venture realizes a liquid liquidity event and is acquired by another company for 250 million. Let us see how the money is distributed. Now they have participating preferred a stock. If it is if they have a participating as well as liquidation preference participating and liquidation preference, then look at what happens.

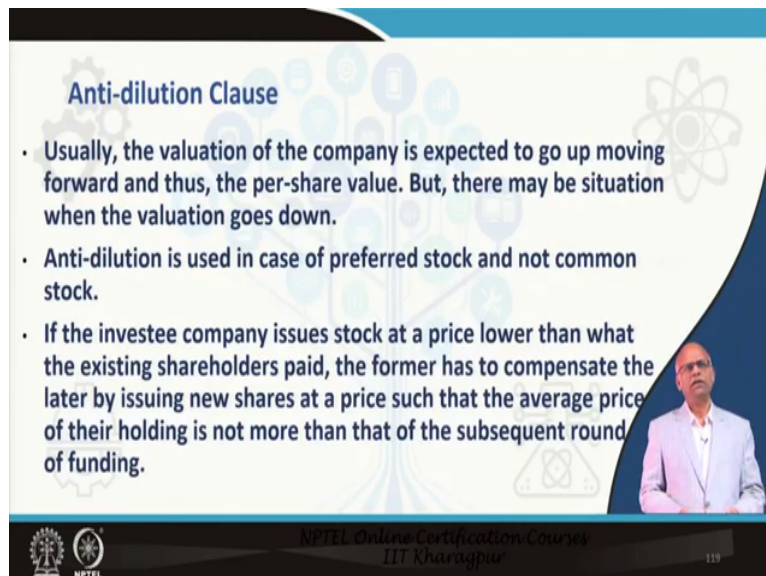
Now, participating means they will get 50 percent of the money that is for share. Suppose there is no liquidation clause, then because it is participating the whole 50 percent of the

equity so, this whole 250 50 million will be distributed 50-50. But if they have a liquidation clause, suppose they have a liquidation preference that is 1X liquidation preference.

So, initially when you are sitting on the on two sides of the table and you are you are deciding about sharing the money they say that we have 1X liquidation clause; that means, give me my 50 million dollar. The invested 50 million dollar. So, they will take the 50 million dollar first. So, out of 250, 50 million dollar gone to them. Now you have 200 dollar; 200 million dollar. So, now, they hold 50 percent of the equity. So, they will take away another 50 percent of the remaining money and you will be left with only 100 million dollar because from 250, they got hundred and 50 million dollar. So, only 100 million dollar is left.

So, the founders will have only 100 million dollar. Let us move forward.

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**Anti-dilution Clause**

- Usually, the valuation of the company is expected to go up moving forward and thus, the per-share value. But, there may be situation when the valuation goes down.
- Anti-dilution is used in case of preferred stock and not common stock.
- If the investee company issues stock at a price lower than what the existing shareholders paid, the former has to compensate the later by issuing new shares at a price such that the average price of their holding is not more than that of the subsequent round of funding.

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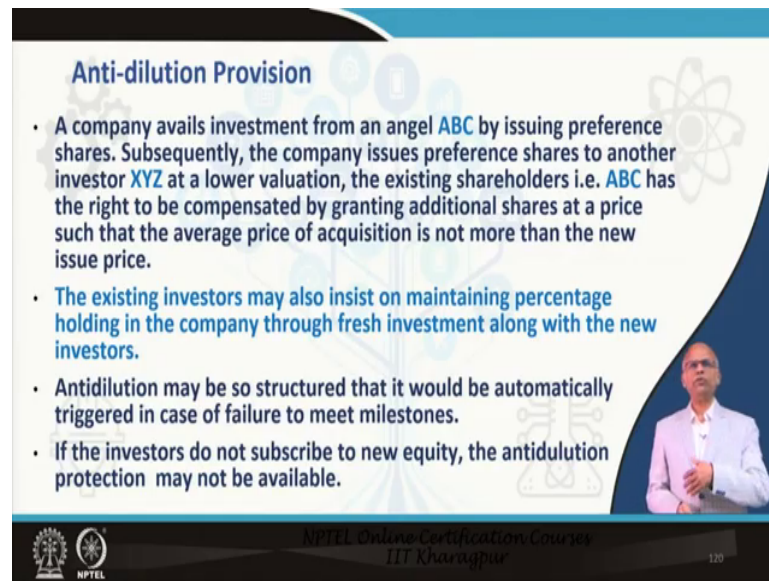
119

Now, this is another example I just mentioned that at the beginning, I will I will repeat. Suppose this preference capital or whatever was convertible preference share and some day they have already converted. The preference share into equity; that means, they got 50 percent equity.

So, after that if there is a liquidity event meaning that somebody has taken over the company for 250 million dollar, they will get just 50 percent because they are at par with the founders now. Founders hold 50 percent equity, they hold 50 percent equity; they will have no preference whatsoever. So, the money will be distributed 50-50. Anti-dilution clause, this is another clause that one should be aware about usually the valuation of the company is expected to go up as you move forward because you develop more product, you have more traction in the market etcetera.

But sometimes you do not do you do not perform well. So, there will be some problem and then next round of funding will be at a lower valuation. But a time, but if earlier investors are clever enough, they will say that if you go for another round of investment, if you provide equity at a lower value then our lower than whatever price at which our share was allocated, then we have to allocate more share at a much lower value. So, that our average value becomes the present value at whatever rate you are offering shares now that is anti dilution clause.

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**Anti-dilution Provision**

- A company avails investment from an angel **ABC** by issuing preference shares. Subsequently, the company issues preference shares to another investor **XYZ** at a lower valuation, the existing shareholders i.e. **ABC** has the right to be compensated by granting additional shares at a price such that the average price of acquisition is not more than the new issue price.
- The existing investors may also insist on maintaining percentage holding in the company through fresh investment along with the new investors.
- Antidilution may be so structured that it would be automatically triggered in case of failure to meet milestones.
- If the investors do not subscribe to new equity, the antidilution protection may not be available.

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120

So, there is all those anti dilution meaning. They may even increase their activity, they may say that our equity holding is 50 percent and it should always remain 50 percent even if new investors come. So, you have to continuously miss at every stage, you have to give them new equity. So, that they are holding does not go down.

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**Other Preference**

Drag-along provisions – it grants investors the right to compel the founders and other shareholders to vote in favor of the sale, merger, or other “deemed liquidation”.

The slide features a central graphic of a tree with circular nodes. Surrounding the tree are icons: a gear, a lightbulb, a molecular structure, a hard hat, and a circuit board. A small inset video shows a man in a white shirt speaking. The footer includes the NPTEL logo, the text 'NPTEL Online Certification Courses IIT Kharagpur', and the number '121'.

Drag along provision meaning that they whatever they decide the founders will have to fall in line, they may not be able to challenge that is called drag alone provision.

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**An Example of Preferred Shares**

- A BA group invests ₹ 50 million for 25% of a venture. The venture is sold for ₹ 100 million.
- **Case I: no liquidity preference**
  - The BA group would receive ₹ 25 million and lose 50% of their original investment. The entrepreneur or common shareholders would receive ₹ 75 million.
- **Case II: BA group has a 1X liquidity (non-participating) preference**
  - The BA group would receive ₹ 50 million. The entrepreneur or common shareholders would receive the remaining ₹ 50 million.
- **Case III: BA group negotiates a 1X 'participating preference'**
  - The BA group receives their ₹ 50 million plus another ₹ 12.5 million (25% of the remaining ₹ 50 million). The entrepreneur or common shareholders would receive only ₹ 37.5 million.

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Here are some examples very quickly. A BA a group invest 50 million dollar 50 million rupees for 20 percent 25percent of a venture. If they say that 25 percent of a venture, now the question is how much is the value of the enterprise if 50 million makes 25 percent of the venture. That means, they are getting 50 means 50 million is equal to 25 percent. So, you divide 50 divide 50 with 0.25, you get the total value post money total value.

Now, suppose one someday the venture is sold for 100 million, venture is sold for 100 million. Now under different clauses different conditionalities of this preference share, let us see how the share of the money varies; share between say angel and founder. First clause no liquidity preference, they hold 25 percent because there is no liquidity preference, they will get twenty five percent of the money; that means, 25 million. So, they lose 75 million because they have brought in 100 million.

Case number 2, they have 1X liquidity clause as well as 25 percent holding. So, because they have 1X liquidity clause so, they will take away they are 1X money whatever they have invested. They have invested 100 million dollar or 50 million 50 million dollar.

So, they will take away the 50 million dollar at the beginning. What remains only 50 million; now they will also take 25 percent of that provided they have participatory. If they do not have participant; if suppose there is no 25 percent mentioned, they will get only 50 percent 50 million. And if it is mentioned that they are also participating and it is 25percent of the share that the hold then they will get another 12.5 million. So, the total will be 75 50 plus 12.5. So, it is going to be 62.5 percent.

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**Another Example of Preferred Shares:  
Further clarified.**

- A BA group invests ₹ 50 million for 25% of a venture. The venture is sold for ₹ 100 million.
- Post money valuation:  $50M/0.25 = 200M$
- Premoney valuation =  $200M - 50M = 150M$
- **Case I: no liquidity preference**
  - The BA group holds 25% of equity in the company. With no liquidation clause, they would receive only 25% of the proceeds: i.e. 25% of 100 M = ₹ 25 million.
  - Their original investment is ₹ 50 million. So, they lose 50% of their original investment.
  - The entrepreneur or common shareholders would receive ₹ 75 million.

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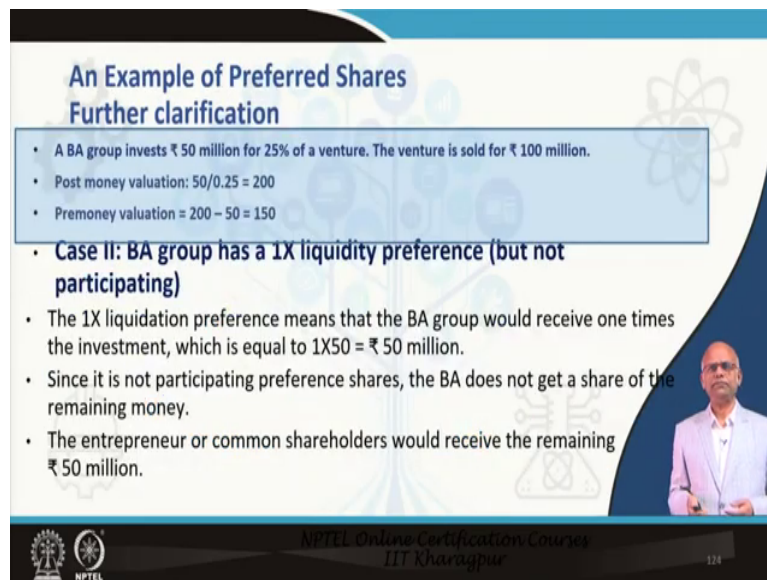
121



And the investors will get 35 point 37.5percent. Another example, BA group invest 50 million for 25 percent of a venture. The venture is sold for 100 million, the same example post money valuation is 50 divided by 0.25 is 200 million.

Then pre money value is 200 million minus the 50 million that they brought in is 150 million. Just a back calculation, try to understand this very clearly. Now case 1, there is no liquidity preference the BA group hold, 25percent. If there is no liquidity preference, they get 25 percent of the sales proceed, their original investment is 50 million. So, they lose 75 million.

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**An Example of Preferred Shares**  
**Further clarification**

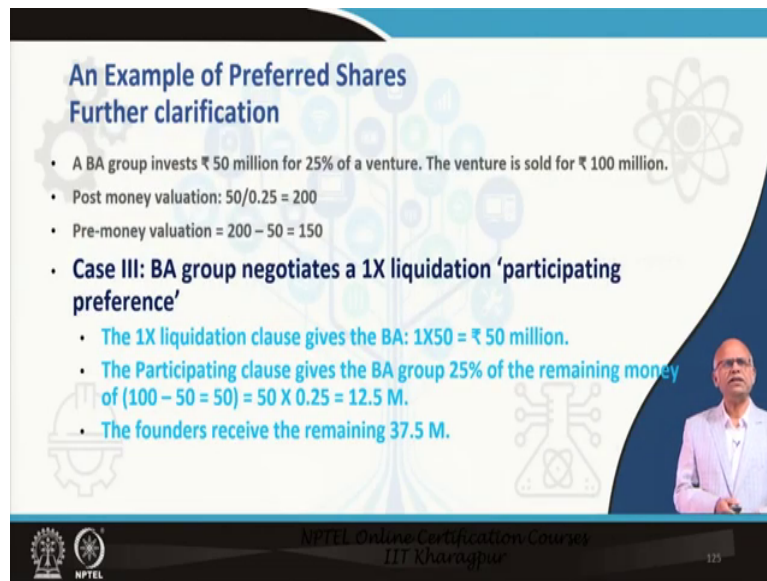
- A BA group invests ₹ 50 million for 25% of a venture. The venture is sold for ₹ 100 million.
- Post money valuation:  $50/0.25 = 200$
- Premoney valuation =  $200 - 50 = 150$
- **Case II: BA group has a 1X liquidity preference (but not participating)**
  - The 1X liquidation preference means that the BA group would receive one times the investment, which is equal to  $1 \times 50 = ₹ 50$  million.
  - Since it is not participating preference shares, the BA does not get a share of the remaining money.
  - The entrepreneur or common shareholders would receive the remaining ₹ 50 million.

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124

Now, suppose this is case number 2, BA group as 1X liquidity preference. So, they get 50 million since it is not participating, they should be happy with that 50 million.

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**An Example of Preferred Shares**  
**Further clarification**

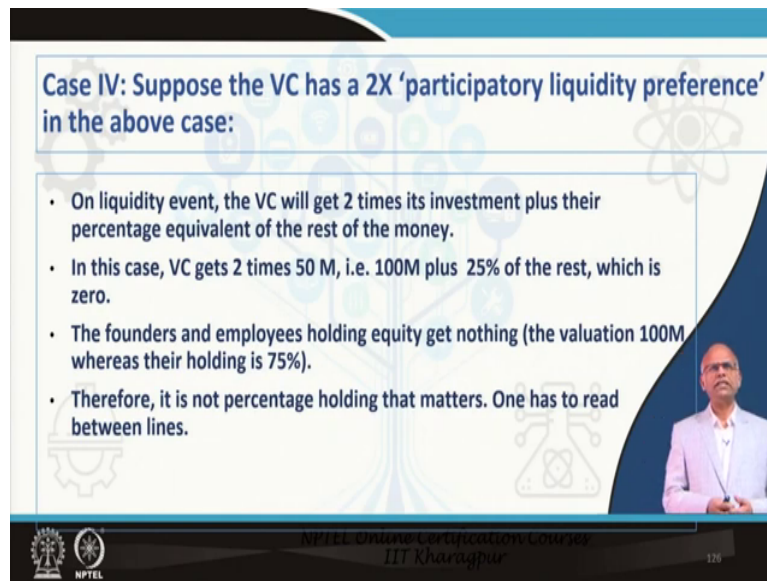
- A BA group invests ₹ 50 million for 25% of a venture. The venture is sold for ₹ 100 million.
- Post money valuation:  $50/0.25 = 200$
- Pre-money valuation =  $200 - 50 = 150$
- **Case III: BA group negotiates a 1X liquidation 'participating preference'**
  - The 1X liquidation clause gives the BA:  $1 \times 50 = ₹ 50$  million.
  - The Participating clause gives the BA group 25% of the remaining money of  $(100 - 50 = 50) = 50 \times 0.25 = 12.5$  M.
  - The founders receive the remaining 37.5 M.

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125

So, under prisoners that I think this is a repetition of the previous slides, BA group negotiate 1X right, this is a repetition again.

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**Case IV: Suppose the VC has a 2X 'participatory liquidity preference' in the above case:**

- On liquidity event, the VC will get 2 times its investment plus their percentage equivalent of the rest of the money.
- In this case, VC gets 2 times 50 M, i.e. 100M plus 25% of the rest, which is zero.
- The founders and employees holding equity get nothing (the valuation 100M whereas their holding is 75%).
- Therefore, it is not percentage holding that matters. One has to read between lines.

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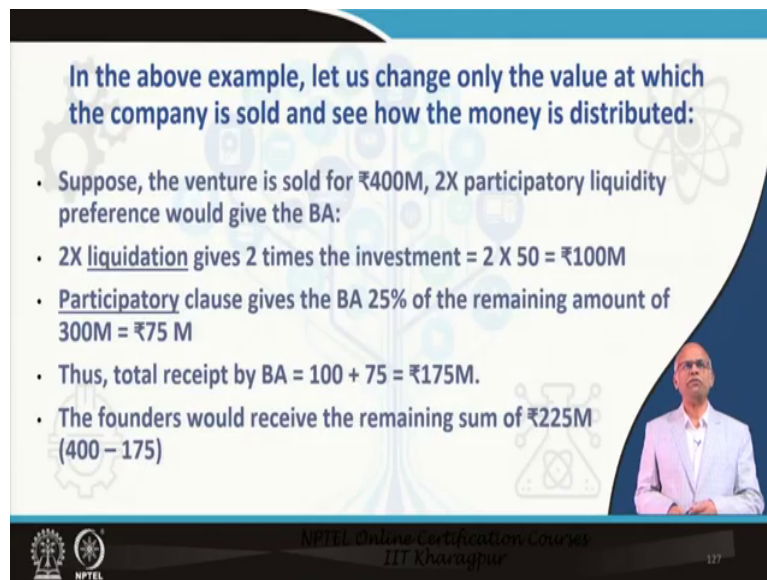
So, case number 4, suppose BA group has 2X repeat participatory and liquidity preference; 2X liquidity preference. This is very important.

Now, see on liquidity event VA or BA whatever that is they get 2 times their money. So, they invested 50 million dollar. At the beginning itself they will say, we want our investment multiplied by 2 at the beginning it itself. So, they will take 50 multiplied by tw2; that means, 100 million dollar away. So, out of 100 million, they get 100 million at the beginning it itself. So, nothing remains if something will remains, they will take another 25 percent because it is participatory.

Now, founders get nothing. Now the founders of or they lose all the money. Therefore, the founders and the employees holding equity get nothing if the valuation is 100. Therefore, it is not really percent is holding that matters, you hold 75 percent; you may think that we hold 75

percent. So, we are if the valuation is 100 million dollar, we get 75million it is not so, it depends on the condition that is what I wanted to drive on the point that is why all repetition.

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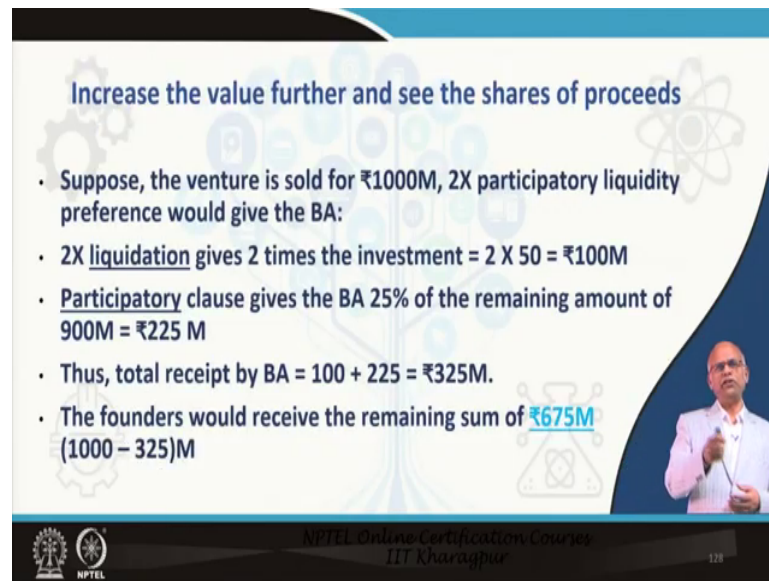
**In the above example, let us change only the value at which the company is sold and see how the money is distributed:**

- Suppose, the venture is sold for ₹400M, 2X participatory liquidity preference would give the BA:
- 2X liquidation gives 2 times the investment =  $2 \times 50 = ₹100M$
- Participatory clause gives the BA 25% of the remaining amount of  $300M = ₹75 M$
- Thus, total receipt by BA =  $100 + 75 = ₹175M$ .
- The founders would receive the remaining sum of ₹225M  $(400 - 175)$

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Now, suppose the venture is sold for 400 million with 2X liquidity participation you will find that 2X liquidity, they get 2 times 50; that means, 100 million and then gradually the they get 25 percent of the remaining of the money. So, they get 175 founders get 225.

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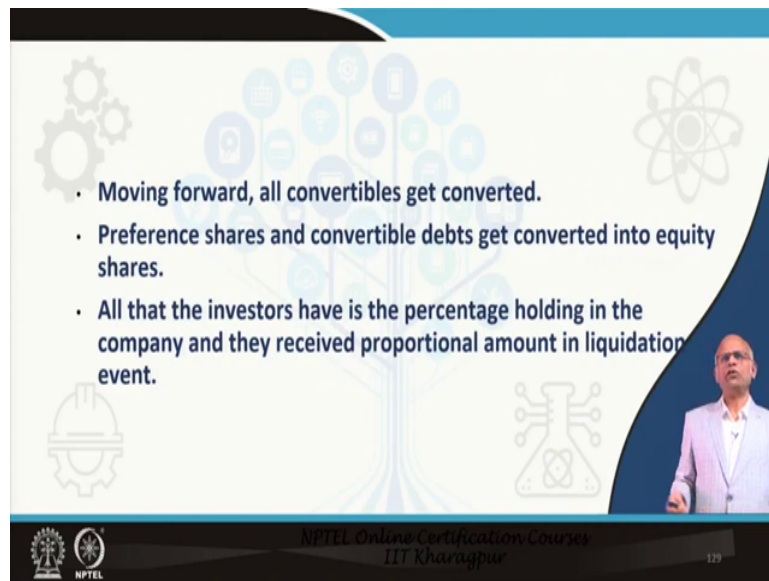
**Increase the value further and see the shares of proceeds**

- Suppose, the venture is sold for ₹1000M, 2X participatory liquidity preference would give the BA:
- 2X liquidation gives 2 times the investment =  $2 \times 50 = ₹100M$
- Participatory clause gives the BA 25% of the remaining amount of  $900M = ₹225 M$
- Thus, total receipt by BA =  $100 + 225 = ₹325M$ .
- The founders would receive the remaining sum of **₹675M**  $(1000 - 325)M$

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So, higher the valuation, the founder gets higher the amount even later example will show you that the founder gets now 675 where are the BA gets only 325 just because you have sold the company at 1 billion dollar or 1000 million dollars. So, higher the valuation, higher the ratio of received by founders and BA VCs.

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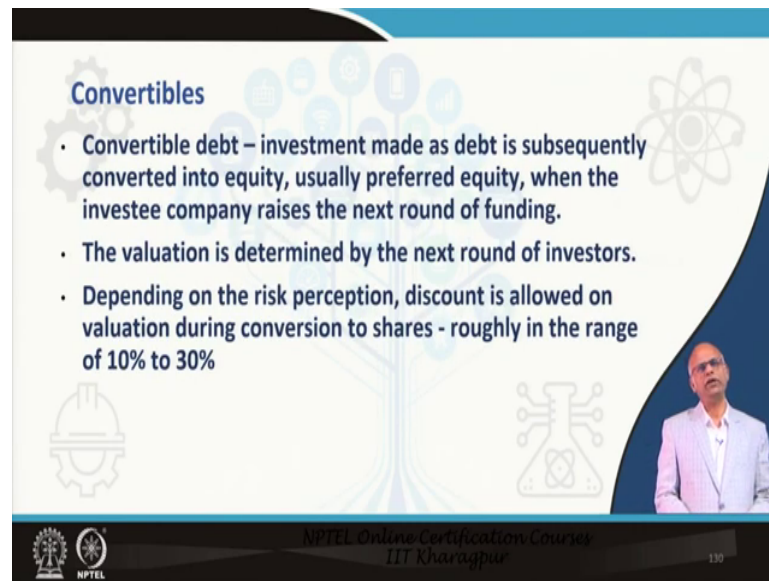
- Moving forward, all convertibles get converted.
- Preference shares and convertible debts get converted into equity shares.
- All that the investors have is the percentage holding in the company and they received proportional amount in liquidation event.

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129

So, moving forward, all convertibles get converted. Preference shares and convertible dates get converted into equity shares. All that investors have is the percentage holding in the company. Suppose they invest in debt or they invest in equity eventually gets converted into share, they are at par with founders.



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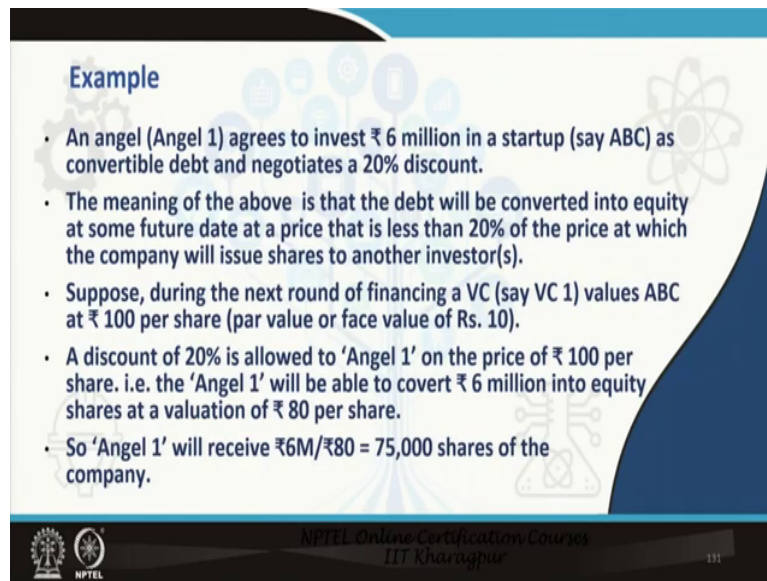
**Convertibles**

- Convertible debt – investment made as debt is subsequently converted into equity, usually preferred equity, when the investee company raises the next round of funding.
- The valuation is determined by the next round of investors.
- Depending on the risk perception, discount is allowed on valuation during conversion to shares - roughly in the range of 10% to 30%

The slide features a background with various icons including a gear, a lightbulb, a bar chart, a network diagram, a hard hat, and a chemical flask. A small inset video shows a man in a light blue suit speaking.


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### Example

- An angel (Angel 1) agrees to invest ₹ 6 million in a startup (say ABC) as convertible debt and negotiates a 20% discount.
- The meaning of the above is that the debt will be converted into equity at some future date at a price that is less than 20% of the price at which the company will issue shares to another investor(s).
- Suppose, during the next round of financing a VC (say VC 1) values ABC at ₹ 100 per share (par value or face value of Rs. 10).
- A discount of 20% is allowed to 'Angel 1' on the price of ₹ 100 per share. i.e. the 'Angel 1' will be able to convert ₹ 6 million into equity shares at a valuation of ₹ 80 per share.
- So 'Angel 1' will receive  $\frac{₹6M}{₹80} = 75,000$  shares of the company.

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131




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## Convertible Debt

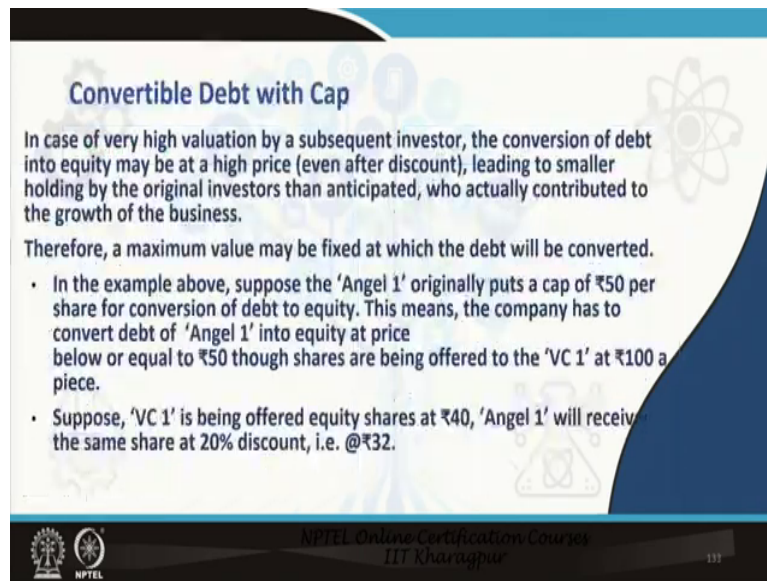
### Advantages and Disadvantages of Investee Company

Advantages	Disadvantages
<ul style="list-style-type: none"><li>• Funding does not dilute equity.</li><li>• Can avoid estimating pre-money valuation.</li><li>• Chances of lower dilution after value accretion.</li><li>• Can avoid bias of earlier valuation when approaching to subsequent investors. Avoid down round.</li><li>• Less processing and quick disbursal.</li><li>• Investor may opt not to convert</li></ul>	<ul style="list-style-type: none"><li>• May have to pay interest on debt and stress cash flow.</li><li>• May lead to higher dilution for the same amount of fund if it fails to meet performance milestones.</li><li>• Higher discount rate may lead to higher dilution.</li><li>• If there is 'cap' on pre-money valuation, the investee company may not avoid dilution.</li><li>• No voting right</li></ul>

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137

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### Convertible Debt with Cap

In case of very high valuation by a subsequent investor, the conversion of debt into equity may be at a high price (even after discount), leading to smaller holding by the original investors than anticipated, who actually contributed to the growth of the business.

Therefore, a maximum value may be fixed at which the debt will be converted.

- In the example above, suppose the 'Angel 1' originally puts a cap of ₹50 per share for conversion of debt to equity. This means, the company has to convert debt of 'Angel 1' into equity at price below or equal to ₹50 though shares are being offered to the 'VC 1' at ₹100 a piece.
- Suppose, 'VC 1' is being offered equity shares at ₹40, 'Angel 1' will receive the same share at 20% discount, i.e. @₹32.

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I will close it here. We will discuss the rest of the slides in the next session.

So, thank you very much.