Entrepreneurial Finance (FIN-E0309)
Negotiation Exercise

The assignment is to be done in groups of four. The same groups will also be used in the course's three exercise sets. Collaboration between different groups is prohibited (except for own group's negotiation counterparty in issues related to the negotiation exercise).

Return the different parts of the assignment to the respective submission boxes under the assignments tab of the MyCourses course page. The group registration tool is available under the same tab. The deadlines (sharp!) are as follows:

- Group registration:	***1.00 PM on Friday, March 1, 2024***
- Selection of negotiation counterparty:	***1.00 PM on Thursday, March 7, 2024***
- Entrepreneurial groups' first-round submissions:	***10.00 AM on Monday, March 11, 2024***
- Investor groups' first-round submissions:	***10.00 AM on Monday, March 18, 2024***
- Final submissions of all groups:	***9.00 AM on Wednesday, April 10, 2024***

The negotiation exercise is a simulation exercise in which students are divided into groups of four and put against another group in an attempt to negotiate financing terms for a venture capital investment. Students are free to choose their own group members using the group selection tool in the MyCourses course page, but the groups' assigned role as either an entrepreneurial firm seeking financing or an investor, will be determined by the instructor (who assigns the roles randomly). The deadline for the group registration is Friday, March 1 at 1.00 PM, shortly after which groups are informed of their assigned role. In addition to their own group members, groups may also select their negotiation counterparty (i.e. the investor group for an entrepreneurial group and vice versa). The instructor needs to be informed by email of any self-selected negotiation pairs by 1.00 PM on Thursday, March 7. Any remaining groups' negotiation pairs will be assigned randomly shortly after the deadline. The discussion forum on the MyCourses course page can be used to find group members as well as the negotiation counterparty, if needed.

The goal of the exercise is to teach students to plan and eventually negotiate financing terms that are in line with their incentives given the assigned role of the group. In one of the final lectures of the course, a final presentation of the negotiation outcome lasting approximately 20 minutes will take place. In each presentation, the entrepreneurial group and the investor group should be allocated approximately equal amounts of time. The presentation will culminate in the two parties either agreeing to certain compromise terms under which the investment is made, or the parties not being able to reach an agreement.

The entrepreneurial groups are expected to aim to raise an amount that is in line with the chosen firm's unique needs and future projections, while the exact sum will be ultimately decided by the negotiations. Although the major focus of the entrepreneurial groups should be placed on raising equity from the venture capitalist, other financing possibilities are also encouraged to be considered. The entrepreneurial groups are encouraged to develop and use their own business ideas in the exercise. Alternatively, they have the option of using a template firm (Omega Biotech) with a pre-developed business idea, team, and history. This template is on purpose rudimentary, leaving room for different financial scenarios for different groups.

After deciding on what business to continue with, the entrepreneurial groups are expected to develop financial forecasts and plan for the timing, amount and type of capital they need to raise. Based on these managerial forecasts, the investor groups will then in turn propose a preliminary term sheet to the corresponding entrepreneurial groups. Following this initial proposition, the investor groups will continue with a thorough due diligence of the venture and start negotiating over the terms of the preliminary term sheet that the entrepreneurial group may have indicated to disagree with.

The negotiations culminate in the final presentation that takes place at the end of the course as described above. In the presentation, both parties present their initial views over the key components of the venture such as the realism of the venture's future projections, its valuation and key terms. The presentation should reflect if and how both parties' initial views and requirements have changed during the negotiations and why. For example, the investor group may have found out something new during the due diligence process that drove them to increase their required rate of return. Alternatively, the entrepreneurial group may have been able to demonstrate their expertise in the business and thus convince the investors to offer looser terms. After presenting the starting points of the negotiations and going through what has changed, the groups are expected to present what they have ultimately decided: whether the financing contract is signed and if so, under what terms.

Apart from giving a verbal presentation, all groups are required to submit the slides from their presentations. These slides (the "slide pack") constitute the final report, and they should thus be self-contained. The relatively short duration of the presentation means that some slides belonging to the pack may not be presented in the verbal presentation. The deadline for the final submission of all groups is on Wednesday, April 10 at 9.00 AM. In order to ensure a smooth evaluation of the presentations, groups are required to clearly state their group name (the alphabet from the MyCourses group registration tool) in the beginning of the discussion as well as include it in their slides.

Although a lot of communication will take place between the two groups, not all negotiations are required to be submitted. There will be one required submission for both groups prior to the final discussion. The entrepreneurial group is required to submit its business idea (or decide to use the template firm) and the corresponding future projections, whereas the investor group needs to submit its take on the future projections and the preliminary term sheet it proposes to the entrepreneurial group before any actual negotiations. The deadline for the first-round submissions for the entrepreneurial groups is Monday, March 11, at 10.00 AM, while the deadline for the investor groups is Monday, March 18, at 10.00 AM. Both groups are also expected to explain the assumptions or views behind their projections or claims in both their submissions as well as in their negotiations between one another. The maximum length of the first-round entrepreneurial and investor group reports is 10 pages.

Students are encouraged to evaluate all of the other groups' final negotiations (except for that of the students' own negotiation pair) but only required to do so for all negotiations in either of the two sessions. Thus, in case a student has to skip one of the negotiation sessions, they are required to attend the other in order to provide the evaluations. The peer evaluation will determine half of the negotiation exercise grade (i.e., 15% of course total), while the other half is determined by the instructor.

Negotiation Exercise structure and required submissions

Stage #1

- **Entrepreneurial Group** comes up with a business idea (or continues with the Omega Biotech template firm) and develops a future plan for the venture. The entrepreneurial groups are required to develop the following documents:
    - **A written description of the business idea** discussing at least the following issues:
        - What will the venture do? When and how? What is the current state of the venture?
        - Why will the venture be profitable and where does the demand come from? What is the competitive environment like?
        - Could new unforeseen obstacles such as required certifications appear?
        - How much capital do you currently have and how much is still needed?
    - **A Gantt chart laying out milestones** for the different parts of the company over the next years (See *WorkHorse Box 3.1 The Timeline* in the course textbook as an example)
    - **Financial Plan** consisting of at least the following issues:
        - Revenue estimates
        - Cost estimates (cost of goods sold, operating expenses, and capital expenditures)
        - Pro Forma financial statements (income statement, balance sheet, cash flow)
    - The textbook has an excellent website including, among others, tools for evaluating venture opportunities and for preparing financial plans: https://www.entrepreneurialfinance.net/courseware
- Entrepreneurial groups are required to submit their written business ideas with the accompanying Gantt charts and properly justified financial plans.

Stage #2

- **Investor Group** will familiarize itself with the business idea and the feasibility of the entrepreneurial group's managerial forecasts. As a response to the entrepreneurial group, the investor group develops the following documents:
    - **A preliminary term sheet** and the accompanying **capitalization table** using the templates attached below.
        - The template includes critical key terms most often negotiated in term sheets. Technically, only valuation, the type of security issued and the required equity stake in the venture need to be agreed upon to raise capital. However, students are encouraged to include other terms of the template in their term sheets and negotiations as they see fit, in order to better mimic a real-world situation.
    - **Supporting calculations and comments** behind the terms required as well as behind the possibly differing financial projections and the consequent valuation
- Investor groups are required to submit the preliminary term sheets along with the supporting calculations/comments.

- The following optional reading material is recommended for getting a better understanding of different terms:
  Chapters 4, 5 and 6 of the book *Venture Deals: Be Smarter Than Your Lawyer and Venture Capitalist 3rd edition*, by Brad Feld and Jason Mendelson (2016) (Available as an e-book from Aalto:
  https://primo.aalto.fi/permalink/358AALTO_INST/1rd34t9/alma999144864406526)
  Alternatively, Brad Feld has also written a number of blog posts on the topic, although some material is partly overlapping with the book:
  https://feld.com/archives/2008/06/revisiting-the-term-sheet.html

Stage #3

- **Entrepreneurial Group** is likely to disagree with some of the terms proposed by the investor group in the preliminary term sheet. They inform the investor group of these disagreements and thus begin negotiations.

Stage #4

- **Investor group** starts to conduct further due diligence on the business and its industry after sending in the preliminary term sheet and contacts the entrepreneurial group if and when needed with questions. In the meantime, both groups may end up revising their future projections and therefore also their term sheet requirements.

Stage #5

- **Investor** and **Entrepreneurial groups** meet up in the final presentation in which they go through their initial projections and analyses as well as preliminary requirements. Groups are expected to present how their initial views have changed and why they are for example now willing to agree to certain terms they previously didn't agree to. Ultimately, the groups are required to decide whether the financing contract is signed and if so, under what terms. Students need to have the actual negotiations done prior to the final discussion and instead of debating the terms, focus on giving a smooth presentation/discussion that won't exceed 20 minutes and that demonstrates how and why the final outcome differs from the initial proposition. The two negotiation partners are advised to coordinate their presentations in advance so as to give a smooth overall impression on the negotiation outcome.
- Groups are required to submit the presentation slides prior to any of the final presentations. If the slides used in the presentation don't contain all of the negotiation aspects and reasonings, these should be included in supplementary slides, preferably at the end of the document.
- Group name (the alphabet given by the MyCourses group selection tool) needs to be clearly stated in the beginning of the presentations.

Omega Biotech: A Template business idea for the Negotiation Exercise

Omega Biotech has been developing DHA (docosahexaenoic acid, omega-3 fatty acid) products for years but is yet to experience a real commercial breakthrough. The venture currently faces competition from a few major supplement manufacturers but also from several smaller ventures. The venture's goal is to develop products that could be used to increase the amount of healthy DHA in food products, without affecting the taste of the products significantly, as would happen if fatty fish oil was used.

Currently, the venture is growing DHA rich algae and other plants, from which it extracts chemicals that are used to enhance the fatty acid profile of for example yogurts and cottage cheeses. The venture believes there to be a rather significant market for a new type of product that can be added to candies and other treats, allowing customers to enjoy their treats while also taking care of their health. Hence, they are currently planning to focus their products' R&D and marketing efforts towards this but believe that additional capital is required before being able to make any meaningful breakthroughs.

After spending years on developing the products with the help of an investor who owns 30% of the common stock, the venture successfully began operations mid-2022, with 2023 being its first full operative year. The existing investor has indicated she isn't interested in increasing her stake in the venture further and that her expertise lies more in the development phase rather than commercialization of the product. Therefore, a new investor ought to be brought in. Currently, there are 12 000 shares of common stock outstanding.

The venture's income statement and balance sheet for the financial year 2023 are below.

Income Statement for the year ending December 31, 2023 (€)

Revenue	750 000
Operating expenses	-650 000
EBIT	100 000
Interest expenses	-20 000
Earnings before taxes	80 000
Taxes (20% rate)	-16 000
Net income	64 000
Cash dividends (50% payout)	-32 000
Added retained earnings	32 000

Balance Sheet as of December 31, 2023 (€)

Cash and marketable securities	50 000	Accounts payable	80 000
Accounts receivable	100 000	Bank loan	90 000
Inventories	110 000	Accrued liabilities	60 000
Total current assets	260 000	Total current liabilities	230 000
		Long-term debt	110 000
		Common stock	120 000
Fixed assets, net	340 000	Retained earnings	140 000
Total assets	600 000	Total liabilities and equity	600 000

Term sheet template for the Negotiation Exercise

SERIES A PREFERRED STOCK FINANCING OF
[*INSERT COMPANY NAME*], INC.
[__________ __, 2024]

Offering Terms

Security:	Series A Preferred Stock (the "**Series A Preferred**").
Expected Closing Date:	[_______] (the "**Closing**").
Investor:	Investor No. 1: [_______] shares ([__]%)
Amount Raised:	€[________].
Pre-Money Valuation:	The price per share of the Series A Preferred (the "**Original Purchase Price**") shall be the price determined on the basis of a fully-diluted pre-money valuation of €[___] (which pre-money valuation shall include an [unallocated and uncommitted] employee option pool representing [__]% of the fully diluted post-money capitalization) and a fully diluted post-money valuation of €[______].
Capitalization:	The Company's capital structure before and after the Closing is set forth on the attached capitalization table.
Liquidation Preference & Participation:	• Will the stock issued be Non-participating Preferred or Participating Preferred (with or without a cap)? o Typically, Non-participating Preferred stock with a 1x liquidation preference is issued. Multiple preferences often appear in later-stage or distressed financings. In practically all VC deals, the preferred shareholders can convert their stake into common stock at any time.
Anti-dilution Provisions:	• Will there be any Anti-Dilution Provisions in place? If yes, will they be structured as Full Ratchet or Weighted Average Anti-Dilution? o Typically, a Weighted Average Provision is used, although a Full Ratchet benefits the investors a lot more.

Employee Stock Options:

- Are shares/options reserved in a pool for employees for incentive/compensation reasons? What is their strike price and are they subject to vesting?
    - Typically, 10%-20% of fully diluted capitalization is reserved for employees and a standard vesting period is two to four years. Make sure to reflect the possible ESOP in the capitalization table.

Founder Common Stock Vesting:

- Will the common stock held by the founders vest and if so, under what type of schedule? Vesting can be based on time, milestones, or a combination of the two. Shall accelerated vesting terms be in place?
    - Typically, stock will vest monthly over the next four years with a one-year cliff, meaning that 0% is vested for the first 12 months, after which 25% gets vested. After the cliff, 1/48th or 2.08% more vesting takes place monthly until the four-year mark is reached. There are two commonly used acceleration terms used that can accelerate vesting outside the original schedule: In case the company is sold (single trigger) or the company is sold, and the founder's employment is terminated (double trigger).

Protective Provisions:

- Will the holders of Series A Preferred be granted protective provisions that allow them to exercise a veto right over certain critical actions by the company?
    - Typically, protective provisions are granted over numerous actions but due to the sake of simplicity, only the most critical and standard ones are presented here, and it's not required to go beyond them in the exercise. The provisions are usually agreed as follows: Unless 2/3 or 1/2 (to be negotiated) of the Series A Preferred holders agree, the company can't
        - Authorize the creation of more stock or issue stock senior or equal to the Series A Preferred
        - Sell the company
        - Change the size of board of directors
        - Issue debt in excess of €______

Pre- and Post-Financing Capitalization attachment to the term sheet

	Pre-Financing		Post-Financing	
Security	# of Shares	%	# of Shares	%
Common – Founders				
Common – Employee Stock Pool				
Issued				
Unissued				
Series A Preferred				
Total				

A: THE INVESTMENT

Security:	Series A Preferred Stock (the "**Series A Preferred**").
Expected Closing Date:	[_______] (the "**Closing**").
Investor:	Investor No. 1: [_______] shares ([__]%)
Amount Raised:	€[________].
Pre-Money Valuation:	The price per share of the Series A Preferred (the "**Original Purchase Price**") shall be the price determined on the basis of a fully-diluted pre-money valuation of €[___] (which pre-money valuation shall include an [unallocated and uncommitted] employee option pool representing [__]% of the fully diluted post-money capitalization) and a fully diluted post-money valuation of €[______].
Capitalization:	The Company's capital structure before and after the Closing is set forth on the attached capitalization table.