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## The Glossary of Private Equity and Venture Capital

The Glossary of Private Equity and Venture Capital is the perfect resource for professionals in the private equity and venture capital industries. This glossary is provided to the industry and may be redistributed freely, provided that it is unaltered. Be sure to check VCExperts.com for updates to this glossary and for the latest news, events and information in private equity and venture capital. This copy of the Glossary was prepared on Monday, June 29, 2009. Don't forget to download an updated version as the glossary is updated on a regular basis.

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- # -

**401(K) Plan:** Type of qualified retirement plan in which employees make salary reduced, pre-tax contributions to an employee trust. In many cases, the employer will match employee contributions up to a specified level.

- A -

**"A" Round :** A financing event whereby venture capitalists invest in a company that was previously financed by founders and/or angels. The "A" is from Series "A" Preferred stock. See "B" round.

**Accredited Investor:** Defined by Rule 501 of Regulation D, an individual (i.e. non-corporate) "accredited investor" is either a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds \$1 million at the time of the purchase OR a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year. For the [complete definition of accredited investor](#), see the SEC website.

**Accrued Interest:** The interest due on preferred stock or a bond since the last interest payment was made.

**Acquisition:** The process of gaining control, possession or ownership of a private portfolio company by an operating company or conglomerate.

**ACRS: Accelerated Cost Recovery System.** The IRS approved method of calculating depreciation expense for tax purposes. Also known as **Accelerated Depreciation**.

**Adjustment Condition:** An adjustment condition occurs if the company does not close on an equity investment in the company for a minimum of \$xxx, net of brokerage fees, on or before a series of other predetermined events, i.e. delivery of term sheet to preferred stockholders.

**ADR: American Depositary Receipt (ADR's).** A security issued by a U.S. bank in place of the

foreign shares held in trust by that bank, thereby facilitating the trading of foreign shares in U.S. markets.

**Advisory Board:** A group of external advisors to a private equity group or portfolio company. Advice provided varies from overall strategy to portfolio valuation. Less formal than a Board of Directors.

**Allocation:** The amount of securities assigned to an investor, broker, or underwriter in an offering. An allocation can be equal to or less than the amount indicated by the investor during the subscription process depending on market demand for the securities.

**Alternative Assets:** This term describes non-traditional asset classes. They include private equity, venture capital, hedge funds and real estate. Alternative assets are generally more risky than traditional assets, but they should, in theory, generate higher returns for investors.

**Amortization:** An Accounting procedure that gradually reduces the book value of a tangible or a definite intangible asset through periodic charges to income.

**AMT: Alternative Minimum Tax.** A tax designed to prevent wealthy investors from using tax shelters to avoid income tax. The calculation of the AMT takes into account tax preference items.

**Angel Financing:** Capital raised for a private company from independently wealthy investors. This capital is generally used as seed financing.

**Angel Groups:** Organizations, funds and networks formed for the specific purpose of facilitating angel investments in start-up companies.

**Angel Investor :** A person who provides backing to very early-stage businesses or business concepts. Angel investors are typically entrepreneurs who have become wealthy, often in technology-related industries.

**Antidilution provisions:** Contractual measures that allow investors to keep a constant share of a firm's equity in light of subsequent equity issues. These may give investors preemptive rights to purchase new stock at the offering price. [See Full Ratchet and weighted Average]

**Archangel :** Usually an outsider hired by a syndicate of angel investors to perform due diligence on investment opportunities and coordinate allotment of investment duties among members. Archangels typically have no financial commitment to the syndicate.

**Asset-backed loan:** Loan, typically from a commercial bank, that is backed by asset collateral, often belonging to the entrepreneurial firm or the entrepreneur.

**Automatic conversion:** Immediate conversion of an investor's priority shares to ordinary shares at the time of a company's underwriting before an offering of its stock on an exchange.

**Average IRR:** The arithmetic mean of the internal rate of return.

**- B -**

**"B" Round:** A financing event whereby professional investors such as venture capitalists are sufficiently interested in a company to provide additional funds after the "A" round of financing. Subsequent rounds are called "C", "D", and so on.

**Balance Sheet:** A condensed financial statement showing the nature and amount of a company's assets, liabilities, and capital on a given date.

**Bankruptcy:** An inability to pay debts. Chapter 11 of the bankruptcy code deals with reorganization, which allows the debtor to remain in business and negotiate for a restructuring of debt.

**Barbell Strategy:** Investment strategy by limited partners that primarily make commitments to buyout firms on (1) the micro/small and (2) the large/mega ends of the market; while mostly eschewing the vast array of middle-market opportunities.

**BATNA (best alternative to a negotiated agreement):** A no-agreement alternative reflecting the course of action a party to a negotiation will take if the proposed deal is not possible.

**Bear Hug:** An offer made directly to the Board of Directors of a target company. Usually made to increase the pressure on the target with the threat that a tender offer may follow.

**Benchmarking:** Comparing returns of a portfolio to the returns of its peers; in private equity, fund performance is benchmarked against a sample of funds formed in the same vintage year with the same investment focus.

**Best Efforts:** An offering in which the investment banker agrees to distribute as much of the offering as possible, and return any unsold shares to the issuer.

**Blue Sky Laws:** A common term that refers to laws passed by various states to protect the public against securities fraud. The term originated when a judge ruled that a stock had as much value as a *patch of blue sky*.

**Book Value:** Book value of a stock is determined from a company's balance sheet by adding all current and fixed assets and then deducting all debts, other liabilities and the liquidation price of any preferred issues. The sum arrived at is divided by the number of common shares outstanding and the result is book value per common share.

**Bootstrapping:** Means of financing a small firm by employing highly creative ways of using and acquiring resources without raising equity from traditional sources or borrowing money from the bank.

**Bridge Financing:** A limited amount of equity or short-term debt financing typically raised within 6-18 months of an anticipated public offering or private placement meant to "bridge" a company to the next round of financing.

**Broad-Based Weighted Average Ratchet:** A type of anti-dilution mechanism. A weighted average ratchet adjusts downward the price per share of the preferred stock of investor A due to the issuance of new preferred shares to new investor B at a price lower than the price investor A originally received. Investor A's preferred stock is repriced to a weighed average of investor A's price and investor B's price. A broad-based ratchet uses all common stock outstanding on a fully diluted basis (including all convertible securities, warrants and options) in the denominator of the formula for determining the new weighted average price. Compare Narrow-Based Weighted Average ratchet and Chapter 2.9.4.d.ii of the Encyclopedia.

**Brokers:** Private individuals or firms retained by early-stage companies to raise funds for a finder's fee. (compare, broker-dealer)

**Burn Out / Cram Down:** Extraordinary dilution, by reason of a round of financing, of a non-participating investor's percentage ownership in the issuer.

**Burn Rate:** The rate at which a company expends net cash over a certain period, usually a month.

**Business Development Company (BDC):** A vehicle established by Congress to allow smaller, retail investors to participate in and benefit from investing in small private businesses as well as the revitalization of larger private companies.

**Business Plan:** A document that describes the entrepreneur's idea, the market problem, proposed solution, business and revenue models, marketing strategy, technology, company profile, competitive landscape, as well as financial data for coming years. The business plan opens with a brief executive summary, most probably the most important element of the document due to the time constraints of venture capital funds and angels.

- C -

**CAGR:** Compound Annual Growth Rate. The year over year growth rate applied to an investment or other aspect of a firm using a base amount.

**Call Option:** The right to buy a security at a given price (or range) within a specific time period.

**Capital (or Assets) Under Management:** The amount of capital available to a fund management team for venture investments.

**Capital Call:** Also known as a draw down - When a venture capital firm has decided where it would like to invest, it will approach its investors in order to "draw down" the money. The money will already have been pledged to the fund but this is the actual act of transferring the money so that it reaches the investment target.

**Capital Gains:** The difference between an asset's purchase price and selling price, when the selling price is greater. Long-term capital gains (on assets held for a year or longer) are taxed at a lower rate than ordinary income.

**Capitalization Table:** Also called a "Cap Table", this is a table showing the total amount of the various securities issued by a firm. This typically includes the amount of investment obtained from each source and the securities distributed -- e.g. common and preferred shares, options, warrants, etc. -- and respective capitalization ratios.

**Capitalize:** To record an outlay as an asset (as opposed to an Expense), which is subject to depreciation or amortization.

**Captive funds :** A venture capital firm owned by a larger financial institution, such as a bank.

**Carried Interest:** The portion of any gains realized by the fund to which the fund managers are entitled, generally without having to contribute capital to the fund. Carried interest payments are customary in the venture capital industry, in order to create a significant economic incentive for venture capital fund managers to achieve capital gains.

**Cash Position:** The amount of cash available to a company at a given point in time. Claim Dilution A reduction in the likelihood that one or more of the firm's claimants will be fully repaid, including time value of money considerations.

**Catch-up:** This is a common term of the private equity partnership agreement. Once the general partner provides its limited partners with their preferred return, if any, it then typically enters a catch-up period in which it receives the majority or all of the profits until the agreed upon profit-split, as determined by the carried interest, is reached.

**Chapter 11:** The part of the Bankruptcy Code that provides for **reorganization** of a bankrupt

company's assets.

**Chapter 7:** The part of the Bankruptcy Code that provides for **liquidation** of a company's assets.

**Chinese wall:** A barrier against information flows between different divisions or operating groups within banks and securities firms. Examples include a policy barrier between the trust department from making investment decisions based on any substantive inside information that may come into the possession of other bank departments. The term also refers to barriers against information flows between corporate finance and equity research and trading operations.

**Clawback:** A clawback obligation represents the general partner's promise that, over the life of the fund, the managers will not receive a greater share of the fund's distributions than they bargained for. Generally, this means that the general partner may not keep distributions representing more than a specified percentage (e.g., 20%) of the fund's cumulative profits, if any. When triggered, the clawback will require that the general partner return to the fund's limited partners an amount equal to what is determined to be "excess" distributions. Click here for more [detail](#)

**Closed-end Fund:** A type of fund that has a fixed number of shares outstanding, which are offered during an initial subscription period, similar to an initial public offering. After the subscription period is closed, the shares are traded on an exchange between investors, like a regular stock. The market price of a closed-end fund fluctuates in response to investor demand as well as changes in the values of its holdings or its Net Asset Value. Unlike open-end mutual funds, closed-end funds do not stand ready to issue and redeem shares on a continuous basis.

**Closing:** An investment event occurring after the required legal documents are implemented between the investor and a company and after the capital is transferred in exchange for company ownership or debt obligation.

**Co-investment:** The syndication of a private equity financing round or an investment by an individuals (usually general partners) alongside a private equity fund in a financing round.

**Co-Sale Provisions or Rights :** Allows investors to sell their shares of stock in the same proportions and for the same terms as the founders, managers, or other investors, should any of those parties receive an offer.

**Collar Agreement:** Agreed upon adjustments in the number of shares offered in a stock-for-stock exchange to account for price fluctuations before the completion of the deal.

**Committed Capital:** The total dollar amount of capital pledged to a private equity fund.

**Committed Funds or Raised Funds :** Capital committed by investors. Cash to the maximum of these commitments may be requested or drawn down by the private equity managers usually on a deal-by-deal basis. This amount is different from invested funds for three reasons. First, most partnerships will initially invest only between 80% and 95% of committed funds (possibly even less). Second, it may be necessary in early years to deduct the annual management fee that is used to cover the cost of operation of a fund. Third, payback to investors usually begins before the final draw down of commitments has taken place. To the extent that capital invested does not equal capital committed, limited partners will have their private equity returns diluted by the much lower cash returns earned on the uninvested portion. Avoiding this situation is the main reason for the Partners Group over-commitment model, which aims to keep Partners Group products as close 100% invested as possible.

**Common Stock:** A unit of ownership of a corporation. In the case of a public company, the stock is traded between investors on various exchanges. Owners of common stock are typically entitled to vote on the selection of directors and other important events and in some cases receive

dividends on their holdings. Investors who purchase common stock hope that the stock price will increase so the value of their investment will appreciate. Common stock offers no performance guarantees. Additionally, in the event that a corporation is liquidated, the claims of secured and unsecured creditors and owners of bonds and preferred stock take precedence over the claims of those who own common stock.

**Company buy-back:** The redemption of private or restricted holdings by the portfolio company itself. In essence the company is buying out the VC's interest.

**Consolidation:** Also called a leveraged rollup, this is an investment strategy in which a leveraged buyout (LBO) firm acquires a series of companies in the same or complementary fields, with the goal of becoming a dominant regional or nationwide player in that industry. In some cases, a holding company will be created to acquire the new companies. In other cases, an initial acquisition may serve as the platform through which the other acquisitions will be made.

**Conversion Ratio:** The number of shares of stock into which a convertible security may be converted. The conversion ratio equals the par value of the convertible security divided by the conversion price.

**Conversion Rights:** Rights by which preferred stock "converts" into common stock. Usually, one has this right at any time after making an investment. Company may want rights to force a conversion upon an IPO; upon hitting of certain sales or earnings' targets, or upon a majority or supermajority vote of the preferred stock. Conversion rights may carry with them anti-dilution protections.

**Convertible Security:** A bond, debenture or preferred stock that is exchangeable for another type of security (usually common stock) at a pre-stated price. Convertibles are appropriate for investors who want higher income, or liquidation preference protection, than is available from common stock, together with greater appreciation potential than regular bonds offer. (**See Common Stock, Dilution, and Preferred Stock**).

**Corporate Charter:** The document prepared when a corporation is formed. The Charter sets forth the objectives and goals of the corporation, as well as a complete statement of what the corporation can and cannot do while pursuing these goals.

**Corporate Venturing:** Venture capital provided by [in-house investment funds of] large corporations to further their own strategic interests.

**Corporation:** A legal, taxable entity chartered by a state or the federal government. Ownership of a corporation is held by the stockholders. Two forms: "C Corp." and "S Corp." - the latter of which provides flow-through taxation.

**Covenant:** A protective clause in an agreement.

**Cumulative Dividends:** Dividends that accrue at a fixed rate until paid are "Cumulative Dividends" which are payments to shareholders made with respect to an investor's Preferred Stock. Generally, holders of Preferred Shares are contractually entitled to receive dividends prior to holders of Common Stock. Dividends can accumulate at a fixed rate (for example 8%) or simply be payable as and when determined by a company's Board of Directors in such amount as determined by the board. Because venture backed companies typically need to conserve cash, the use of Cumulative Dividends is customary with the result that the Liquidation Preference increases by an amount equal to the Cumulative Dividends. Cumulative Dividends are often waived if the Preferred Stock converts to Common Stock prior to an IPO but may be included in the aggregate value of Preferred Stock applied to the Conversion Ratio for other purposes. Dividends that are not cumulative are generally called "when, as and if declared dividends."

**Cumulative Preferred Stock:** A stock having a provision that if one or more dividend payments are omitted, the omitted dividends (arrearage) must be paid **before** dividends may be paid on the company's common stock.

**Cumulative Voting Rights:** When shareholders have the right to pool their votes to concentrate them on an election of one or more directors rather than apply their votes to the election of all directors. For example, if the company has 12 openings to the Board of Directors, in statutory voting, a shareholder with 10 shares casts 10 votes for each opening ( $10 \times 12 = 120$  votes). Under the cumulative voting method however, the shareholder may opt to cast all 120 votes for **one** nominee (or any other distribution he might choose). **Compare Statutory Voting.**

**- D -**

**Deal Flow:** The measure of the number of potential investments that a fund reviews in any given period.

**Deal Structure:** An Agreement made between the investor and the company defining the rights and obligations of the parties involved. The process by which one arrives at the final term and conditions of the investment.

**Deficiency Letter:** A letter sent by the SEC to the issuer of a new issue regarding omissions of material fact in the registration statement.

**Demand Rights:** Contemplate that the company must initiate and pursue the registration of a public offering including, although not necessarily limited to, the shares proffered by the requesting shareholder(s).

**Depreciation:** An expense recorded to reduce the value of a long-term tangible asset. Since it is a non-cash expense, it increases free cash flow while decreasing the amount of a company's reported earnings.

**Dilution:** A reduction in the percentage ownership of a given shareholder in a company caused by the issuance of new shares.

**Dilution Protection:** Applies to convertible securities. Standard provision whereby the conversion ratio is changed accordingly in the case of a stock dividend or extraordinary distribution to avoid dilution of a convertible bondholder's potential equity position. Adjustment usually requires a split or stock dividend in excess of 5% or issuance of stock below book value. Share Purchase Agreements also typically contain anti-dilution provisions to protect investors in the event that a future round of financing occurs at a valuation that is below the valuation of the current round.

**Director:** Person elected by shareholders to serve on the board of directors. The directors appoint the president, vice president and all other operating officers, and decide when dividends should be paid (among other matters).

**Disbursement:** The investments by funds into their portfolio companies.

**Disclosure Document:** A booklet outlining the risk factors associated with an investment.

**Distressed debt:** Corporate bonds of companies that have either filed for bankruptcy or appear likely to do so in the near future. The strategy of distressed debt firms involves first becoming a major creditor of the target company by snapping up the company's bonds at pennies on the dollar. This gives them the leverage they need to call most of the shots during either the reorganization, or the liquidation, of the company. In the event of a liquidation, distressed debt

firms, by standing ahead of the equity holders in the line to be repaid, often recover all of their money, if not a healthy return on their investment. Usually, however, the more desirable outcome is a reorganization, which allows the company to emerge from bankruptcy protection. As part of these reorganizations, distressed debt firms often forgive the debt obligations of the company, in return for enough equity in the company to compensate them. (This strategy explains why distressed debt firms are considered to be private equity firms.)

**Distribution:** Disbursement of realized cash or stock to a venture capital fund's limited partners upon termination of the fund.

**Diversification:** The process of spreading investments among various different types of securities and various companies in different fields.

**Dividend:** The payments designated by the Board of Directors to be distributed pro-rata among the shares outstanding. On preferred shares, it is generally a fixed amount. On common shares, the dividend varies with the fortune of the company and the amount of cash on hand and may be omitted if business is poor or if the Directors determine to withhold earnings to invest in capital expenditures or research and development. Dividends can be paid either in cash or in kind, i.e. additional shares of stock.

*Cumulative* - Missed dividend payments that continue to accrue.

*Non-cumulative* - Missed dividend payments that do not accrue.

*Participating* - Dividends which share (participate) with common stock.

*Non-participating* - Dividends which do not share with common stock.

**Down Round:** Issuance of shares at a later date and a lower price than previous investment rounds.

**Drag-Along Rights:** A majority shareholders' right, obligating shareholders whose shares are bound into the shareholders' agreement to sell their shares into an offer the majority wishes to execute.

**Due Diligence:** A process undertaken by potential investors -- individuals or institutions -- to analyze and assess the desirability, value, and potential of an investment opportunity.

**- E -**

**Early Stage:** A state of a company that typically has completed its seed stage and has a founding or core senior management team, has proven its concept or completed its beta test, has minimal revenues, and no positive earnings or cash flows.

**EBITDA:** "Earnings Before Interest, Taxes, Depreciation and Amortization": A measure of cash flow calculated as: Revenue - Expenses (excluding tax, interest, depreciation and amortization). EBITDA looks at the cash flow of a company. By not including interest, taxes, depreciation and amortization, we can clearly see the amount of money a company brings in. This is especially useful when one company is considering a takeover of another because the EBITDA would cover any loan payments needed to finance the takeover.

**Economies of Scale:** Economic principle that as the volume of production increases, the cost of producing each unit decreases.

**Elevator Pitch:** An extremely concise presentation of an entrepreneur's idea, business model, company solution, marketing strategy, and competition delivered to potential investors. Should not last more than a few minutes, or the duration of an elevator ride.

**Employee Stock Option Plan (ESOP):** A plan established by a company whereby a certain number of shares is reserved for purchase and issuance to key employees. Such shares usually vest over a certain period of time to serve as an incentive for employees to build long term value for the company.

**Employee Stock Ownership Plan:** A trust fund established by a company to purchase stock on behalf of employees.

**Equity:** Ownership interest in a company, usually in the form of stock or stock options.

**Equity Kicker:** Option for private equity investors to purchase shares at a discount. Typically associated with mezzanine financings where a small number of shares or warrants are added to what is primarily a debt financing.

**ERISA:** ERISA shall mean the United States [Employee Retirement Income Security Act of 1974](#), as amended, including the regulations promulgated thereunder.

**ERISA Significant Participation Test:** A test that is satisfied if the General Partner determines in its reasonable discretion that Persons that are "benefit plan investors" within the meaning of Section (f)(2) of the Final Regulation constitute or are expected to constitute at least 25 percent in interest of the Limited Partners. *Note that the test is 25% of the interests of all the limited partners, which means 20% (+/-) in the partnership as a whole, taking into account the general partner's interest.*

**Evergreen Promise:** This occurs when the company agrees to pay an employee's salary for a number of years, regardless of when termination occurs, the day after he or she is employed or 10 years after.

**Exercise price:** The price at which an option or warrant can be exercised.

**Exit Strategy:** A fund's intended method for liquidating its holdings while achieving the maximum possible return. These strategies depend on the exit climates including market conditions and industry trends. Exit strategies can include selling or distributing the portfolio company's shares after an initial public offering (IPO), a sale of the portfolio company or a recapitalization.

**Exiting climates:** The conditions that influence the viability and attractiveness of various exit strategies.

**Exits (AKA divestments or realizations):** The means by which a private equity firm realizes a return on its investment. Private equity investors generally receive their principal returns via a capital gain on the sale or flotation of investments. Exit methods include a trade sale (most common), flotation on a stock exchange (common), a share repurchase by the company or its management or a refinancing of the business (least common). A Secondary purchase of the LP interest by another private equity firm are becoming an increasingly common phenomenon.

**- F -**

**Factoring:** A procedure in which a firm can sell its accounts receivable invoices to a factoring firm, which pays a percentage of the invoices immediately, and the remainder (minus a service fee) when the accounts receivable are actually paid off by the firm's customers.

**Final Regulation:** An ERISA term, it is the United States Department of Labor's Final Regulation relating to the definition of "plan assets" in (29 C.F.R. §2510.3-101).

**Finder:** A person who helps to arrange a transaction.

**First Close** : An early close of part of a round financing upon the agreement of all parties. This is often used as part of a "Rolling closing" strategy.

**First Refusal Rights** : A negotiated obligation of the company or existing investors to offer shares to the company or other existing investors at fair market value or a previously negotiated price, prior to selling shares to new investors.

**Flipping**: The act of buying shares in an IPO and selling them immediately for a profit. Brokerage firms underwriting new stock issues tend to discourage flipping, and will often try to allocate shares to investors who intend to hold on to the shares for some time. However, the temptation to flip a new issue once it has risen in price sharply is too irresistible for many investors who have been allocated shares in a hot issue.

**Flotation**: When a firm's shares start trading on a formal stock exchange, such as the NASDAQ or the NYSE. This is probably the most profitable exit route for entrepreneurs and their financial backers.

**Follow-on funding** : Companies often require several rounds of funding. If a private equity firm has invested in a particular company in the past, and then provides additional funding at a later stage, this is known as 'follow-on funding'.

**Forced Buyback**: Redemption of convertible debt, convertible preferred stock or common stock on pre-specified terms in situations where the company's value has not appreciated according to the agreed upon plan.

**Form 10-K**: This is the annual [report](#) that most reporting companies file with the Commission. It provides a comprehensive overview of the registrant's business. The report must be filed within 90 days after the end of the company's fiscal year.

**Form 10-KSB**: This is the annual [report](#) filed by reporting "small business issuers." It provides a comprehensive overview of the company's business, although its requirements call for slightly less detailed information than required by Form 10-K. The report must be filed within 90 days after the end of the company's fiscal year.

**Form S-1**: The [form](#) can be used to register securities for which no other form is authorized or prescribed, except securities of foreign governments or political sub-divisions thereof.

**Form S-2**: This is a simplified optional registration [form](#) that may be used by companies that have been required to report under the '34 Act for a minimum of three years and have timely filed all required reports during the 12 calendar months and any portion of the month immediately preceding the filing of the registration statement. Unlike Form S-1, it permits incorporation by reference from the company's annual report to stockholders (or annual report on Form 10-K) and periodic reports. Delivery of these incorporated documents as well as the prospectus to investors may be required.

**Form SB-2**: This [form](#) may be used by "small business issuers" to register securities to be sold for cash. This form requires less detailed information about the issuer's business than Form S-1.

**Founder Vesting**: A term imposed on founders of seed and early stage deals in which the founder ownership is subject to a vesting schedule with nothing up front and linear vesting over, typically, four years. The first twelve months ownership is often "cliff" vested after the first year with monthly vesting thereafter. For more mature companies, vesting credit can be applied at the time of investment. The purpose of this term is to protect investors from an early, unplanned exit by the founder and to provide investors with the equity necessary to attract a new management team.

**Founders' Shares:** Shares owned by a company's founders upon its establishment.

**Free cash flow:** The cash flow of a company available to service the capital structure of the firm. Typically measured as ***operating cash flow less capital expenditures and tax obligations***.

**Full Ratchet Antidilution:** The sale of a single share at a price less than the favored investors paid reduces the conversion price of the favored investors' convertible preferred stock "to the penny". For example, from \$1.00 to 50 cents, regardless of the number of lower priced shares sold.

**Fully Diluted Earnings Per Share:** Earnings per share expressed as if all outstanding convertible securities and warrants have been exercised.

**Fully Diluted Outstanding Shares:** The number of shares representing total company ownership, including common shares and current conversion or exercised value of the preferred shares, options, warrants, and other convertible securities.

**Fund age:** The age of a fund (in years) from its first takedown to the time an IRR is calculated.

**Fund Focus :** The indicated area of specialization of a venture capital fund usually expressed as Balanced, Seed and Early Stage, Later Stage, Mezzanine or Leveraged Buyout (LBO).

**Fund of funds:** A fund set up to distribute investments among a selection of private equity fund managers, who in turn invest the capital directly. Fund of funds are specialist private equity investors and have existing relationships with firms. They may be able to provide investors with a route to investing in particular funds that would otherwise be closed to them. Investing in fund of funds can also help spread the risk of investing in private equity because they invest the capital in a variety of funds.

**Fund Size:** The total amount of capital committed by the investors of a venture capital fund.

**- G -**

**GAAP: Generally Accepted Accounting Principles.** The common set of accounting principles, standards and procedures. GAAP is a combination of authoritative standards set by standard-setting bodies as well as accepted ways of doing accounting.

**Gatekeeper :** Specialist advisers who assist institutional investors in their private equity allocation decisions. Institutional investors with little experience of the asset class or those with limited resources often use them to help manage their private equity allocation. Gatekeepers usually offer tailored services according to their clients' needs, including private equity fund sourcing and due diligence through to complete discretionary mandates.

**GDR's: Global Depositary Receipt (GDR's).** Receipts for shares in a foreign based corporation traded in capital markets around the world. While ADR's permit foreign corporations to offer shares to American citizens, GDR's allow companies in Europe, Asia and the US to offer shares in many markets around the world.

**General Partner (GP):** The partner in a limited partnership responsible for all management decisions of the partnership. The GP has a fiduciary responsibility to act for the benefit of the limited partners (LPs), and is fully liable for its actions.

**General partner clawback:** This is a common term of the private equity partnership agreement.

To the extent that the general partner receives more than its fair share of profits, as determined by the carried interest, the general partner clawback holds the individual partners responsible for paying back the limited partners what they are owed.

**General Partner Contribution:** The amount of capital that the fund manager contributes to its own fund in the same way that a limited partner does. This is an important way in which limited partners can ensure that their interests are aligned with those of the general partner. While the U.S. Department of Treasury has removed the legal requirement of the general partner to contribute at least 1 percent of fund capital. A 1 percent general partner contribution remains standard practice, particularly among venture capital funds.

**Golden Handcuffs:** This occurs when an employee is required to relinquish unvested stock when terminating his employment contract early.

**Golden Parachute:** Employment contract of upper management that provides a large payout upon the occurrence of certain control transactions, such as a certain percentage share purchase by an outside entity or when there is a tender offer for a certain percentage of a company's shares. Discussed in more detail at [The Executive Employment Agreement](#)

- H -

**Harvest:** Reaping the benefits of investment in a privately held company by selling the company for cash or stock in a publicly held company, also known as an "exit strategy".

**Hockey Stick Projections:** The general shape and form of a chart showing revenue, customers, cash, or some other financial or operational measure that increases dramatically at some point in the future. Entrepreneurs often develop business plans with hockey stick charts to impress potential investors.

**Holding Company:** A corporation that owns the securities of another, in most cases with voting control.

**Holding Period:** The amount of time an investor has held an investment. The period begins on the date of purchase and ends on the date of sale, and determines whether a gain or loss is considered short-term or long-term, for capital gains tax purposes.

**Hot Issue:** A newly issued stock that is in great public demand. Technically, it is when the **secondary market price on the effective date is above the new issue offering price**. Hot issues usually experience a dramatic rise in price at their initial public offering because the market demand outweighs the supply.

**Hurdle Rate:** The internal rate of return that a fund must achieve before its general partners or managers may receive an increased interest in the proceeds of the fund. Often, if the expected rate of return on an investment is below the hurdle rate, the project is not undertaken.

- I -

**Incubator :** An entity designed to nurture business concepts or new technologies to the point that they become attractive to venture capitalists. An incubator typically provides both physical space and some or all of the services-legal, managerial, and/or technical-needed for a business concept to be developed. Incubators often are backed by venture firms, which use them to generate early-stage investment opportunities.

**Information Rights:** Rights granting access to company's information, i.e. inspecting the

company books and receiving financial statements, budgets and executive summaries.

**Initial Public Offering (IPO):** The sale or distribution of a stock of a portfolio company to the public for the first time. IPOs are often an opportunity for the existing investors (often venture capitalists) to receive significant returns on their original investment. During periods of market downturns or corrections the opposite is true.

**Institutional Investors:** Organizations that professionally invest, including insurance companies, depository institutions, pension funds, investment companies, mutual funds, and endowment funds.

**Intellectual property :** A venture's legally protectable intangible assets. The major forms of intellectual property are utility patents, design patents, plant patents, copyrights, mask works, trade names, domain names, rights of personality, trade secrets and trademarks/servicemarks. These rights vary from country to country in both term and scope.

**Investment Bankers :** Representatives of financial institutions engaged in the issue of new securities, including management and underwriting of issues as well as securities trading and distribution.

**Investment Company Act of 1940:** Investment Company Act shall mean the [Investment Company Act of 1940](#), as amended, including the rules and regulations promulgated thereunder.

**Investment Letter:** A letter signed by an investor purchasing unregistered long securities under Regulation D, in which the investor attests to the long-term investment nature of the purchase. These securities must be held for a minimum of 1 year before they can be sold.

**IRA Rollover:** The reinvestment of assets received as a lump-sum distribution from a qualified tax-deferred retirement plan. Reinvestment may be the entire lump sum or a portion thereof. If reinvestment is done within 60 days, there are no tax consequences.

**IRR:** Internal Rate of Return. A typical measure of how VC Funds measure performance. IRR is a technically a discount rate: the rate at which the present value of a series of investments is equal to the present value of the returns on those investments.

**ISO:** Incentive Stock Option. Plan which qualifying options are free of tax at the date of grant and the date of exercise. Profits on shares sold after being held at least 2 years from the date of grant or 1 year from the date of exercise are subject to favorable capital gains tax rate. [Click here for detail from the VC Encyclopedia.](#)

**Issue Price :** The price per share deemed to have been paid for a series of Preferred Stock. This number is important because Cumulative Dividends, the Liquidation Preference and Conversion Ratios are all based on Issue Price. In some cases, it is not the actual price paid. The most common example is where a company does a bridge financing (a common way for investors to provide capital without having to value the Company as a whole) and sells debt that is convertible into the next series of Preferred Stock sold by the Company at a discount to the Issue Price.

**Issued Shares:** The amount of common shares that a corporation has sold (issued).

**Issuer:** Refers to the organization issuing or proposing to issue a security.

- J -

**J-Curve Effect:** The curve realized by plotting the returns generated by a private equity fund against time (from inception to termination). The common practice of paying the management fee

and start-up costs out of the first draw-down does not produce an equivalent book value. As a result, a private equity fund will initially show a negative return. When the first realizations are made, the fund returns start to rise quite steeply. After about three to five years, the interim IRR will give a reasonable indication of the definitive IRR. This period is generally shorter for buyout funds than for early-stage and expansion funds.

## - K -

**Key Employees:** Professional management attracted by the founder to run the company. Key employees are typically retained with warrants and ownership of the company.

**Key man clause:** If a specified number of key named executives cease to devote a specified amount of time to the Partnership, which may also include time spent on other funds managed by the manager, during the commitment period, the "key man" clause provides that the manager of the fund is prohibited from making any further new investments (either automatically or if so determined by investors) until such a time that new replacement key executives are appointed. The manager will, however, usually be permitted to make any investments that had already been agreed to be made prior to such date.

## - L -

**Later Stage:** A fund investment strategy involving financing for the expansion of a company that is producing, shipping and increasing its sales volume. Later stage funds often provide the financing to help a company achieve critical mass in order to position its shareholders for an Exit Event, e.g. an IPO or strategic sale of the company.

**Lead Investor:** Also known as a bell cow investor. Member of a syndicate of private equity investors holding the largest stake, in charge of arranging the financing and most actively involved in the overall project

**Lemon :** An investment that has a poor or negative rate of return. An old venture capital adage claims that "lemons ripen before plums."

**Leveraged Buyout (LBO):** A takeover of a company, using a combination of equity and borrowed funds. Generally, the target company's assets act as the collateral for the loans taken out by the acquiring group. The acquiring group then repays the loan from the cash flow of the acquired company. For example, a group of investors may borrow funds, using the assets of the company as collateral, in order to take over a company. Or the management of the company may use this vehicle as a means to regain control of the company by converting a company from public to private. In most LBOs, public shareholders receive a premium to the market price of the shares.

**Lifestyle firms :** Category comprising around 90 percent of all start-ups. These firms merely afford a reasonable living for their founders, rather than incurring the risks associated with high growth. These ventures typically have growth rates below 20 percent annually, have five-year revenue projections below \$10 million, and are primarily funded internally-only very rarely with outside equity funds.

**Limited Partner (LP):** An investor in a limited partnership who has no voice in the management of the partnership. LP's have limited liability and usually have priority over GP's upon liquidation of the partnership.

**Limited partner clawback:** This is a common term of the private equity partnership agreement. It is intended to protect the general partner against future claims, should the general partner of the limited partnership become the subject of a lawsuit. Under this provision, a fund's limited partners

commit to pay for any legal judgment imposed upon the limited partnership or the general partner. Typically, this clause includes limitations in the timing or amount of the judgment, such as that it cannot exceed the limited partners' committed capital to the fund.

**Limited Partnerships:** An organization comprised of a general partner, who manages a fund, and limited partners, who invest money but have limited liability and are not involved with the day-to-day management of the fund. In the typical venture capital fund, the general partner receives a management fee and a percentage of the profits (or carried interest). The limited partners receive income, capital gains, and tax benefits.

**Liquidation:** 1) The process of converting securities into cash. 2) The sale of the assets of a company to one or more acquirers in order to pay off debts. In the event that a corporation is liquidated, the claims of secured and unsecured creditors and owners of bonds and preferred stock take precedence over the claims of those who own common stock.

**Liquidation Preference:** The amount per share that a holder of a given series of Preferred Stock will receive prior to distribution of amounts to holders of other series of Preferred Stock of Common Stock. This is usually designated as a multiple of the Issue Price, for example 2X or 3X, and there may be multiple layers of Liquidation Preferences as different groups of investors buy shares in different series. For example, holders of Series B Preferred Stock may be entitled to receive 3X their Issue Price, and then if any money is left, holders of Series A Preferred Stock may be entitled to receive 2X their Issue Price and then holders of Common Stock receive whatever is left. The trigger for the payment of the Liquidation Preference is a sale or liquidation of the company, such as a merger or other transaction where the company stockholders end up with less than half of the ownership of the new entity or a liquidation of the company.

**Liquidity Event:** An event that allows a VC to realize a gain or loss on an investment. The ending of a private equity provider's involvement in a business venture with a view to realizing an internal return on investment. Most common exit routes include Initial Public Offerings [IPOs], buy backs, trade sales and secondary buy outs. See also: Exit strategy

**LLC - Limited liability company :** A company owned by "members" who either manage the business themselves or appoint "managers" to run it for them. All members and managers have the benefit of limited liability, and, in most cases, are taxed in the same way as a subchapter S corporation, i.e. flow-through taxation, without having to conform to the S Corporation restrictions.

**Lock-up Period:** The period of time that certain stockholders have agreed to waive their right to sell their shares of a public company. Investment banks that underwrite initial public offerings generally insist upon lockups of at least 180 days from large shareholders (1% ownership or more) in order to allow an orderly market to develop in the shares. The shareholders that are subject to lockup usually include the management and directors of the company, strategic partners and such large investors. These shareholders have typically invested prior to the IPO at a significantly lower price to that offered to the public and therefore stand to gain considerable profits. If a shareholder attempts to sell shares that are subject to lockup during the lockup period, the transfer agent will not permit the sale to be completed.

**Lower quartile:** The point at which 75% of all returns in a group are greater and 25% are lower.

**- M -**

**Management buy-out (MBO):** A private equity firm will often provide financing to enable current operating management to acquire or to buy at least 50 per cent of the business they manage. In return, the private equity firm usually receives a stake in the business. This is one of the least risky types of private equity investment because the company is already established and the

managers running it know the business - and the market it operates in - extremely well.

**Management Fee:** Compensation for the management of a venture fund's activities, paid from the fund to the general partner or investment advisor. This compensation generally includes an annual management fee.

**Management Team:** The persons who oversee the activities of a venture capital fund.

**Mandatory Redemption:** is a right of an investor to require the company to repurchase some or all of an investor's shares at a stated price at a given time in the future. The purchase price is usually the Issue Price, increased by Cumulative Dividends, if any. Mandatory Redemption may be automatic or may require a vote of the series of Preferred Stock having the redemption right.

**Market Capitalization:** The total dollar value of all outstanding shares. Computed as shares multiplied by current price per share. Prior to an IPO, market capitalization is arrived at by estimating a company's future growth and by comparing a company with similar public or private corporations. (See also Pre-Money Valuation)

**Market Standoff Agreement:** Similar to Lock-Up Agreements and prevents selling company stock for number of predetermined days after a previous stock offering by the company.

**Merchant banking:** An activity that includes corporate finance activities, such as advice on complex financings, merger and acquisition advice (international or domestic), and at times direct equity investments in corporations by the banks.

**Merger:** Combination of two or more corporations in which greater efficiency is supposed to be achieved by the elimination of duplicate plant, equipment, and staff, and the reallocation of capital assets to increase sales and profits in the enlarged company.

**Mezzanine Financing:** Refers to the stage of venture financing for a company immediately prior to its IPO. Investors entering in this round have lower risk of loss than those investors who have invested in an earlier round. Mezzanine level financing can take the structure of preferred stock, convertible bonds or subordinated debt.

**Middle-Market Firms:** Firms with growth prospects of more than 20 percent annually and five-year revenue projections between \$10 million and \$50 million. Less than 10 percent of all start-ups annually, these entrepreneurial firms are the backbone of the U.S. economy.

**Mutual Fund:** A mutual fund, or an open-end fund, sells as many shares as investor demand requires. As money flows in, the fund grows. If money flows out of the fund the number of the fund's outstanding shares drops. Open-end funds are sometimes closed to new investors, but existing investors can still continue to invest money in the fund. In order to sell shares an investor usually sells the shares back to the fund. If an investor wishes to buy additional shares in a mutual fund, the investor must buy newly issued shares directly from the fund. (See Closed-end Funds)

- N -

**Narrow-based weighted average ratchet:** A type of anti-dilution mechanism. A weighted average ratchet adjusts downward the price per share of the preferred stock of investor A due to the issuance of new preferred shares to new investor B at a price lower than the price investor A originally received. Investor A's preferred stock is repriced to a weighed average of investor A's price and investor B's price. A narrow-based ratchet uses only common stock outstanding in the denominator of the formula for determining the new weighed average price. Compare **Broad-Based Weighted Average Ratchet** and Chapter 2.9.4.d.ii of the Encyclopedia for specific

examples.

**NASD:** The **National Association of Securities Dealers**. An mandatory association of brokers and dealers in the over the counter securities business. Created by the *Maloney Act of 1938*, an amendment to the Securities Act of 1934.

**NASDAQ:** An automated information network which provides brokers and dealers with price quotations on securities traded over the counter.

**NDA (Non-disclosure agreement):** An agreement issued by entrepreneurs to potential investors to protect the privacy of their ideas when disclosing those ideas to third parties.

**Net Asset Value (NAV):** NAV is calculated by adding the value of all of the investments in the fund and dividing by the number of shares of the fund that are outstanding. NAV calculations are required for all mutual funds (or open-end funds) and closed-end funds. The price per share of a closed-end fund will trade at either a premium or a discount to the NAV of that fund, based on market demand. Closed-end funds generally trade at a discount to NAV.

**Net Financing Cost:** Also called the cost of carry or, simply, carry, the difference between the cost of financing the purchase of an asset and the asset's cash yield. Positive carry means that the yield earned is greater than the financing cost; negative carry means that the financing cost exceeds the yield earned.

**Net income:** The net earnings of a corporation after deducting all costs of selling, depreciation, interest expense and taxes.

**Net IRR:** IRR if a portfolio or fund taking into account the effect of management fees and carried interest.

**Net Present Value:** An approach used in capital budgeting where the present value of cash inflow is subtracted from the present value of cash outflows. NPV compares the value of a dollar today versus the value of that same dollar in the future after taking inflation and return into account.

**Net present value (NPV):** A firm or project's net contribution to wealth. This is the present value of current and future income streams, minus initial investment.

**New Issue:** A stock or bond offered to the public for the first time. New issues may be initial public offerings by previously private companies or additional stock or bond issues by companies already public. New public offerings are registered with the Securities and Exchange Commission. (See Securities and Exchange Commission and Registration).

**Newco:** The typical label for any newly organized company, particularly in the context of a leveraged buyout.

**No Shop, No Solicitation Clauses:** A no shop, no solicitation, or exclusivity, clause requires the company to negotiate exclusively with the investor, and not solicit an investment proposal from anyone else for a set period of time after the term sheet is signed. The key provision is the length of time set for the exclusivity period.

**No-fault divorce:** A "no fault divorce" clause permits investors at a time after the final closing date, to remove the general partner of a fund and either terminate the Partnership or appoint a new general partner. This clause covers situations where the general partner has not defaulted or breached the terms and conditions of the Limited Partnership Agreement. Either an ordinary consent or a special consent may be required to effectuate the removal of the general partner and this clause will usually be subject to the general partner receiving compensation for its

removal.

**Non-Compete Clause:** An agreement often signed by employees and management whereby they agree not to work for competitor companies or form a new competitor company within a certain time period after termination of employment. Governed by state law.

**Nonaccredited:** An investor not considered accredited for a Regulation D offering. (Accredited Investor)

**NYSE:** The **New York Stock Exchange**. Founded in 1792, the largest organized securities market in the United States. The Exchange itself does not buy, sell, own or set prices of stocks traded there. The prices are determined by public supply and demand. Also known as the Big Board.

- O -

**Open-end Fund:** An open-end fund, or a mutual fund, generally sells as many shares as investor demand requires. As money flows in, the fund grows. If money flows out of the fund the number of the fund's outstanding shares drops. Open-end funds are sometimes closed to new investors, but existing investors can still continue to invest money in the fund. In order to sell shares an investor generally sells the shares back to the fund. If an investor wishes to buy additional shares in a mutual fund, the investor generally buys newly issued shares directly from the fund.

**Option Pool:** The number of shares set aside for future issuance to employees of a private company.

**Original Issue Discount:** OID. A discount from par value of a bond or debt-like instrument. In structuring a private equity transaction, the use of a preferred stock with liquidation preference or other clauses that guarantee a fixed payment in the future can potentially create adverse tax consequences. The IRS views this cash flow stream as, in essence, a zero coupon bond upon which tax payments are due yearly based on "phantom income" imputed from the difference between the original investment and "guaranteed" eventual payout. Although complex, the solution is to include enough clauses in the investment agreements to create the possibility of a material change in the cash flows of owners of the preferred stock under different scenarios of events such as a buyout, dissolution or IPO.

**OTC: Over-the-Counter.** A market for securities made up of dealers who may or may not be members of a formal securities exchange. The over-the-counter market is conducted over the telephone and is a negotiated market rather than an auction market such as the NYSE.

**Outstanding Stock:** The amount of common shares of a corporation which are in the hands of investors. It is ***equal to the amount of issued shares less treasury stock***.

**Oversubscription:** Occurs when demand for shares exceeds the supply or number of shares offered for sale. As a result, the underwriters or investment bankers must allocate the shares among investors. In private placements, this occurs when a deal is in great demand because of the company's growth prospects.

**Oversubscription Privilege:** In a rights issue, arrangement by which shareholders are given the right to apply for any shares that are not purchased.

- P -

**Paid-in Capital:** The amount of committed capital a limited partner has actually transferred to a venture fund. Also known as the cumulative takedown amount.

**Pari Passu:** At an equal rate or pace, without preference.

**Participating Preferred:** A preferred stock in which the holder is entitled to the stated dividend, and also to additional dividends on a specified basis upon payment of dividends to the common stockholders. The preferred stock entitles the owner to receive a predetermined sum of cash (usually the original investment plus accrued dividends) if the company is sold or has an IPO. The common stock represents additional continued ownership in the company.

**Participation:** Describes a right of a holder of Preferred Stock to enjoy both the rights associated with the Preferred Stock and also participate in any benefit available to Common Stock, without converting to Common Stock. This may occur with Liquidation Preferences, for example, a series of Preferred Stock may have the right to receive its Liquidation Preference and then also share in whatever money is left to be distributed to the holders of Common Stock. Dividends may also be "Participating" where after a holder of Preferred Stock receives its Cumulative Dividend it also receives any dividend paid on the Common Stock.

**Partnership:** A nontaxable entity in which each partner shares in the profits, losses and liabilities of the partnership. Each partner is responsible for the taxes on its share of profits and losses.

**Partnership agreement:** The contract that specifies the compensation and conditions governing the relationship between investors (LP's) and the venture capitalists (GP's) for the duration of a private equity fund's life.

**Pay to Play :** A "Pay to Play" provision is a requirement for an existing investor to participate in a subsequent investment round, especially a Down Round. Where Pay to Play provisions exist, an investor's failure to purchase its pro-rata portion of a subsequent investment round will result in conversion of that investor's Preferred Stock into Common Stock or another less valuable series of Preferred Stock.

**Penny Stocks:** Low priced issues, often highly speculative, selling at less than \$5/share.

**Piggyback Registration:** A situation when a securities underwriter allows existing holdings of shares in a corporation to be sold in combination with an offering of new public shares.

**PIK Debt Securities:** (Payment in Kind) PIK Debt are bonds that may pay bondholders compensation in a form other than cash.

**PIV: Pooled Investment Vehicle.** A legal entity that pools various investor's capital and deploys it according to a specific investment strategy.

**Placement Agent:** A company that specializes in finding institutional investors that are willing and able to invest in a private equity fund or company issuing securities. Sometimes the "issuer" will hire a placement agent so the fund partners can focus on management issues rather than on raising capital. In the U.S., these companies are regulated by the NASD and SEC.

**Plain English Handbook:** The Securities and Exchange Commission online version of [Plain English Handbook: How to Create Clear SEC Disclosure Documents](#)

**Plum:** An investment that has a very healthy rate of return. The inverse of an old venture capital adage (see Lemons) claims that "plums ripen later than lemons."

**Poison Pill:** A right issued by a corporation as a preventative antitakeover measure. It allows rightholders to purchase shares in either their company or in the combined target and bidder entity at a **substantial discount**, usually 50%. This discount may make the takeover prohibitively

expensive.

**Pooled IRR:** A method of calculating an aggregate IRR by summing cash flows together to create a portfolio cash flow. The IRR is subsequently calculated on this portfolio cash flow.

**Portfolio Companies:** Companies in which a given fund has invested.

**Post-Money Valuation:** The valuation of a company immediately after the most recent round of financing. For example, a venture capitalist may invest \$3.5 million in a company valued at \$2 million "pre-money" (before the investment was made). As a result, the startup will have a post-money valuation of \$5.5 million.

**Pre-Money Valuation:** The valuation of a company prior to a round of investment. This amount is determined by using various calculation models, such as discounted P/E ratios multiplied by periodic earnings or a multiple times a future cash flow discounted to a present cash value and a comparative analysis to comparable public and private companies.

**Preemptive Right:** A shareholder's right to acquire an amount of shares in a future offering at current prices per share paid by new investors, whereby his/her percentage ownership remains the same as before the offering.

**Preference shares:** Shares of a firm that encompass preferential rights over ordinary common shares, such as the first right to dividends and any capital payments.

**Preferred Dividend:** A dividend ordinarily accruing on preferred shares payable where declared and superior in right of payment to common dividends.

**Preferred return (AKA Hurdle Rate):** The minimum return to investors to be achieved before a carry is permitted. A hurdle rate of 10% means that the private equity fund needs to achieve a return of at least 10% per annum before the profits are shared according to the carried interest arrangement.

**Preferred Stock:** A class of capital stock that may pay dividends at a specified rate and that has priority over common stock in the payment of dividends and the liquidation of assets. Many venture capital investments use preferred stock as their investment vehicle. This preferred stock is convertible into common stock at the time of an IPO.

**Private Equity:** Equity securities of companies that have not "gone public" (are not listed on a public exchange). Private equities are generally illiquid and thought of as a long-term investment. As they are not listed on an exchange, any investor wishing to sell securities in private companies must find a buyer in the absence of a marketplace. In addition, there are many transfer restrictions on private securities. Investors in private securities generally receive their return through one of three ways: an initial public offering, a sale or merger, or a recapitalization.

**Private investment in public equities (PIPES):** Investments by a hedge fund or private equity fund in unregistered (restricted) securities of a publicly traded company, usually at a discount to the then-prevailing price of the company's registered common stock.

**Private Placement :** Also known as a **Reg. D offering**. The sale of a security (or in some cases, a bond) directly to a limited number of investors. Avoids the need for S.E.C. registration if the securities are purchased for investment as opposed to being resold. The size of the issue is not limited, but its sale is limited to a maximum of thirty-five nonaccredited investors.

**Private Placement Memorandum :** Also known as an Offering Memorandum or "PPM". A document that outlines the terms of securities to be offered in a private placement. Resembles a business plan in content and structure. A formal description of an investment opportunity written

to comply with various federal securities regulations. A properly prepared PPM is designed to provide specific information to the buyers in order to protect sellers from liabilities related to selling unregistered securities. Typically PPMs contain: a complete description of the security offered for sale, the terms of the sales, and fees; capital structure and historical financial statements; a description of the business; summary biographies of the management team; and the numerous risk factors associated with the investment. In practice, the PPM is not generally used in angel or venture capital deals, since most sophisticated investors perform thorough due diligence on their own and do not rely on the summary information provided by a typical PPM.

**Private Securities:** Private securities are securities that are not registered and do not trade on an exchange. The price per share is set through negotiation between the buyer and the seller or issuer.

**Prospectus:** A formal written offer to sell securities that provides an investor with the necessary information to make an informed decision. A prospectus explains a proposed or existing business enterprise and must disclose any material risks and information according to the securities laws. A prospectus must be filed with the SEC and be given to all potential investors. Companies offering securities, mutual funds, and offerings of other investment companies including Business Development Companies are required to issue prospectuses describing their history, investment philosophy or objectives, risk factors and financial statements. Investors should carefully read them prior to investing.

**Put option:** The right to **sell** a security at a given price (or range) within a given time period.

- Q -

**QPAM:** Qualified professional asset manager as defined by ERISA.

- R -

**Ratchet :** Ratchets reduce the price at which venture capitalists can convert their debt into preferred stock, which effectively increases their percentage of equity. Often referred to as an "antidilution adjustment." See Anti-dilution, full ratchet and weighted average.

**Recapitalization:** The reorganization of a company's capital structure. A company may seek to save on taxes by replacing preferred stock with bonds in order to gain interest deductibility. Recapitalization can be an alternative exit strategy for venture capitalists and leveraged buyout sponsors. (See Exit Strategy and Leveraged Buyout)

**Reconfirmation:** The act a broker/dealer makes with an investor to confirm a transaction.

**Red Herring:** The common name for a preliminary prospectus, due to the red SEC required legend on the cover. (See Prospectus)

**Redeemable Preferred Stock:** Redeemable preferred stock, also known as exploding preferred, at the holder's option after (typically) five years, which in turn gives the holders (potentially converting to creditors) leverage to induce the company to arrange a liquidity event. The threat of creditor status can move the founders off the dime if a liquidity event is not occurring with sufficient rapidity.

**Redemption:** The right or obligation of a company to repurchase its own shares.  
Redemption Rights - Rights to force the company to purchase shares (a "put") and more infrequently the company's right to force investor to sell their shares (a "call"). A Put allows one to liquidate an investment in the event an IPO or public merger becomes unlikely. One may also negotiate a Put effective when the company defaults or fails to make payments upon a key

employee's death, etc.

**Registration:** The SEC's review process of all securities intended to be sold to the public. The SEC requires that a registration statement be filed in conjunction with any public securities offering. This document includes operational and financial information about the company, the management and the purpose of the offering. The registration statement and the prospectus are often referred to interchangeably. Technically, the SEC does not "approve" the disclosures in prospectuses.

**Registration Rights:** Provisions in the investment agreement that allow investors to sell stock via the public market. Means by which one can transfer shares in compliance with the securities laws subject to Lock-Up and Market Stand-off Agreements.

Long-form Demand - Demand registration before the company becomes public.

Usually starts one-three years after making an investment and may involve one or two demands for a percentage of stock. Company will use the SEC's long-form S-1.

Short-form Demand - Demand made after the company is publicly traded and is eligible to use SEC's Form S-3.

*Piggyback* - Company is registering stock either for itself or other stockholders and one can "piggyback" a portion of shares for registration onto the company's registration. Usually have these rights for up to five years after the company becomes public, but cannot exercise them for mergers or employee offerings.

**Regulation A:** SEC provision for simplified registration for small issues of securities. A Reg. A issue may require a shorter prospectus and carries lesser liability for directors and officers for misleading statements. The conditional small issues securities exemption of the [Securities Act of 1933](#) is allowed if the offering is a maximum of \$5,000,000 U.S. Dollars.

**Regulation C:** The [regulation](#) that outlines registration requirements for Securities Act of 1933.

**Regulation D:** [Regulation D](#), is the rule (Reg. D is a "regulation" comprising a series of "rules") that allow for the issuance and sale of securities to purchasers if they qualify as accredited investors.

**Regulation D Offering:** (See Private Placement)

**Regulation S:** The rules relating to offers and sales made outside the U.S. without SEC Registration.

**Regulation S-B :** [Reg. S-B](#) of the Securities Act of 1933 governs the Integrated Disclosure System for Small Business Issuers.

**Regulation S-K :** The [Standard Instructions](#) for Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975.

**Regulation S-X:** The [regulation](#) that governs the requirements for financial statements under the Securities Act of 1933, and the Securities Exchange Act of 1934.

**Reorganization or Corporate Reorganization:** Reorganizations are significant changes in the equity base of a company such as converting all outstanding shares to Common Stock, or combining outstanding shares into a smaller number of shares (a reverse split). A Reorganization is frequently done when a company has already had a few rounds of venture financing but has not been able to successfully increase the value of the company and therefore is doing a Down Round that is essentially a restart of the company.

**Restricted Securities:** Public securities that are not freely tradable due to SEC regulations. (See Securities and Exchange Commission)

**Restricted Shares:** Shares acquired in a private placement are considered restricted shares and may not be sold in a public offering absent registration, or after an appropriate holding period has expired. Non-affiliates must wait one year after purchasing the shares, after which time they may sell less than 1% of their outstanding shares each quarter. For affiliates, there is a two-year holding period.

**Revlon Duties:** The legal principle that actions, such as anti-takeover measures, that **promote** the value of an auction process are allowable, whereas those that thwart the value of an auction process are not allowed. The duty is triggered when a company is in play as a target acquisition.

**Right of First Refusal:** The right of first refusal gives the holder the right to meet any other offer before the proposed contract is accepted.

**Rights Offering:** Issuance of "rights" to current shareholders allowing them to purchase additional shares, usually at a discount to market price. Shareholders who do not exercise these rights are usually diluted by the offering. Rights are often transferable, allowing the holder to sell them on the open market to others who may wish to exercise them. Rights offerings are particularly common to closed-end funds, which cannot otherwise issue additional ordinary shares.

**Risk:** The chance of loss on an investment due to many factors including inflation, interest rates, default, politics, foreign exchange, call provisions, etc. In Private Equity, risks are outlined in the Risk Factors section of the Placement Memorandum.

**Rule 144:** Rule 144 provides for the sale of restricted stock and control stock. Filing with the SEC is required prior to selling restricted and control stock, and the number of shares that may be sold is limited.

**Rule 144A:** A safe harbor exemption from the registration requirements of Section 5 of the 1933 Act for resales of certain restricted securities to qualified institutional buyers, which are commonly referred to as "QIBs." In particular, [Rule 144A](#) affords safe harbor treatment for reoffers or resales to QIBs - by persons other than issuers - of securities of domestic and foreign issuers that are not listed on a U.S. securities exchange or quoted on a U.S. automated inter-dealer quotation system. Rule 144A provides that reoffers and resales in compliance with the rule are not "distributions" and that the reseller is therefore not an "underwriter" within the meaning of Section 2(a)(11) of the 1933 Act. If the reseller is not the issuer or a dealer, it can rely on the exemption provided by Section 4(1) of the 1933 Act. If the reseller is a dealer, it can rely on the exemption provided by Section 4(3) of the 1933 Act.

**Rule 147:** Provides an exemption from the registration requirements of the Securities Act of 1933 for intrastate offerings, if certain requirements are met. One requirement is that 100% of the purchasers must be from within one state.

**Rule 501:** [Rule 501 of Regulation D](#) defines Accredited Investor.

**Rule 504:** Company can raise up to \$1 million in any 12-month period from any number or investors provided that the company does not advertise the sale. There are restrictions on the resale of the securities, but there is no requirement of disclosure. Investors need not to be sophisticated nor is any formal private offering memorandum required. However, offering is subject to the general antifraud provisions of the federal securities laws requiring that all material information be accurately presented to purchasers.

**Rule 505:** [Rule 505 of Regulation D](#) is an exemption for limited offers and sales of securities not

exceeding \$5,000,000. Company can raise up to \$5 million in a 12-month period. Security sales can be made to an unlimited number of accredited investor plus 35 additional investors. Disclosure documents, i.e. a private placement memorandum, must be delivered to all non-accredited investors. If dealing with accredited investors, the number of these is unlimited, but there is no advertising allowed.

**Rule 506:** [Rule 506 of Regulation D](#) is considered a "safe harbor" for the private offering exemption of Section 4(2) of the Securities Act of 1933. Companies using the Rule 506 exemption can raise an unlimited amount of money if they meet certain exemptions. No more than 35 non-accredited investors can be involved, and all must be sophisticated. Sellers are restricted from general solicitation and advertising of the sale.

**- S -**

**S Corporation:** A corporation that limits its ownership structure to 100 shareholders and disallows certain types of shareholders [e.g. partnerships cannot hold shares in a S corporation.] An S corporation does not pay taxes, rather, similar to a partnership, its owners pay taxes on their proportion of the corporation's profits at their individual tax rates.

**SBIC :** Small Business Investment Company. A company licensed by the Small Business Administration to receive government leverage in order to raise capital to use in venture investing.

**SBIR:** Small Business Innovation Research Program. See Small Business Innovation Development Act of 1982.

**Secondary funds :** Partnerships that specialize in purchasing the portfolios of investee company investments of an existing venture firm. This type of partnership provides some liquidity for the original investors. These secondary partnerships, expecting a large return, invest in what they consider to be undervalued companies. The big difference is that they are buying their interests in a fund after the fund has been at least partially deployed in underlying portfolio companies. Unlike fund of fund managers, which generally invest in blind pools, secondary buyers can evaluate the underlying companies that they are indirectly investing in.

**Secondary Market:** The market for the sale of partnership interests in private equity funds. Sometimes limited partners chose to sell their interest in a partnership, typically to raise cash or because they cannot meet their obligation to invest more capital according to the takedown schedule. Certain investment companies specialize in buying these partnership interests at a discount.

**Secondary Sale:** The sale of private or restricted holdings in a portfolio company to other investors. See secondary market definition.

**Securities Act of 1933:** The [federal law](#) covering new issues of securities. It provides for full disclosure of pertinent information relating to the new issue and also contains antifraud provisions.

**Securities Act of 1934:** The [federal law](#) that established the Securities and Exchange Commission. The act outlaws misrepresentation, manipulation and other abusive practices in the issuance of securities.

**Securities and Exchange Commission :** The SEC is an independent, nonpartisan, quasi-judicial regulatory agency that is responsible for administering the federal securities laws. These laws protect investors in securities markets and ensure that investors have access to all material information concerning publicly traded securities. Additionally, the SEC regulates firms that trade

securities, people who provide investment advice, and investment companies.

**Seed Money:** The first round of capital for a start-up business. Seed money usually takes the structure of a loan or an investment in preferred stock or convertible bonds, although sometimes it is common stock. Seed money provides startup companies with the capital required for their initial development and growth. Angel investors and early-stage venture capital funds often provide seed money.

**Seed Stage Financing:** An initial state of a company's growth characterized by a founding management team, business plan development, prototype development, and beta testing.

Series A - first round of institutional investment capital

Series B - second round of institutional investment capital

Series C - third round of institutional investment capital

**Senior Securities:** Securities that have a preferential claim over common stock on a company's earnings and in the case of liquidation. Generally, preferred stock and bonds are considered senior securities.

**Series A Preferred Stock:** The first round of stock offered during the seed or early stage round by a portfolio company to the venture investor or fund. This stock is convertible into common stock in certain cases such as an IPO or the sale of the company. Later rounds of preferred stock in a private company are called Series B, Series C and so on.

**Shell Corporation:** A corporation with no assets and no business. Typically, shell corporations are designed for the purpose of going public and later acquiring existing businesses. Also known as Specified Purpose Acquisition Companies (SPACs).

**Small Business Administration (SBA):** Provides loans to small business investment companies (SBICs) that supply venture capital and financing to small businesses.

**Small Business Innovation Development Act of 1982:** The [Small Business Innovation Research \(SBIR\) program](#) is a set-aside program (2.5% of an agency's extramural budget) for domestic small business concerns to engage in Research/Research and Development (R/R&D) that has the potential for commercialization. The SBIR program was established under the Small Business Innovation Development Act of 1982 (P.L. 97-219), reauthorized until September 30, 2000 by the Small Business Research and Development Enhancement Act (P.L. 102-564), and reauthorized again until September 30, 2008 by the Small Business Reauthorization Act of 2000 (P.L. 106-554).

**Special purpose vehicle :** A special company, usually outside the United States, established by a company to meet a specific financial problem, often to pay lower taxes (e.g., a re invoicing subsidiary or offshore insurance company).

**Spin out:** A division or subsidiary of a company that becomes an independent business. Typically, private equity investors will provide the necessary capital to allow the division to "spin out" on its own; the parent company may retain a minority stake.

**Staggered Board:** This is an antitakeover measure in which the election of the directors is split in separate periods so that only a percentage (e.g. one-third) of the total number of directors come up for election in a given year. It is designed to make taking control of the board of directors more difficult.

**Statutory Voting:** A method of voting for members of the Board of Directors of a corporation. Under this method, a shareholder receives one vote for each share and may cast those votes for each of the directorships. For example: An individual owning 100 shares of stock of a corporation that is electing six directors could cast 100 votes for each of the six candidates. This method

tends to favor the larger shareholders. *Compare Cumulative Voting.*

**Stock Options:** 1) The right to purchase or sell a stock at a specified price within a stated period. Options are a popular investment medium, offering an opportunity to hedge positions in other securities, to speculate on stocks with relatively little investment, and to capitalize on changes in the market value of options contracts themselves through a variety of options strategies. 2) A widely used form of employee incentive and compensation. The employee is given an option to purchase its shares at a certain price (at or below the market price at the time the option is granted) for a specified period of years.

**Strategic Investors:** Corporate or individual investors that add value to investments they make through industry and personal ties that can assist companies in raising additional capital as well as provide assistance in the marketing and sales process.

**Subordinated Debt :** Debt with inferior liquidation privileges to senior debt in case of a bankruptcy; sub debt will carry higher interest rates than senior debt, to which it is subordinated, to compensate for the added risk, and will typically have attached warrants or equity conversion features.

**Subscription Agreement:** The application submitted by an investor wishing to join a limited partnership. All prospective investors must be approved by the General Partner prior to admission as a partner.

**Sweat Equity:** Ownership of shares in a company resulting from work rather than investment of capital--usually founders receive "sweat equity".

**Syndicate:** Underwriters or broker/dealers who sell a security as a group. (See Allocation)

**Syndication :** A number of investors offering funds together as a group on a particular deal. A lead investor often coordinates such deals and represents the group's members. Within the last few years, syndication among angel investors (an angel alliance) has become more common, enabling them to fund larger deals closer to those typifying a small venture capital fund.

**- T -**

**Tag-Along Rights / Rights of Co-Sale:** A minority shareholder protection affording the right to include their shares in any sale of control and at the offered price.

**Takedown Schedule:** A takedown schedule means the timing and size of the capital contributions from the limited partners of a venture fund.

**Target Multiples :** The desired return on investment of private investors in early stage companies, defined in a multiple of the original investment.

**Tax-free reorganizations:** Types of business combinations in which shareholders do not incur tax liabilities. There are four types-A, B, C, and D reorganizations. They differ in various ways in the amount of stock/cash that can be offered. **See Internal Revenue Code Section 368.**

**Tender offer:** An offer to purchase stock made directly to the shareholders. One of the more common ways hostile takeovers are implemented.

**Term Sheet:** Term sheet for equity offering

**Time Value of Money:** The basic principle that money can earn interest, therefore something that is worth \$1 today will be worth more in the future if invested. This is also referred to as future

value.

**Trade sale:** The sale of the equity share of a portfolio company to another company.

**Tranche:** Funds flowing from investors to a company that represent a partial round or an "early close." Subsequent funds of the single round are generally under the same terms and conditions as the first tranche (or early close), however, those funding the early tranches may receive bonus warrant coverage, in consideration of the additional risk. (a French word meaning a slice or cutting)

**Treasury Stock:** Stock issued by a company but later reacquired. It may be held in the company's treasury indefinitely, reissued to the public, or retired. Treasury stock receives no dividends and does not carry voting power while held by the company.

**- U -**

**UBTI:** UBTI, Unrelated Business Taxable Income, is a concern to tax exempt investors in a hedge fund because the receipt of UBTI requires the tax exempt entity to file a tax return that it would not otherwise have to file and pay taxes on income that would otherwise be exempt, at the corporate rate. UBTI includes most business operations income and does not include interest, dividends and gains from the sale or exchange of capital assets. Hedge Funds trade their own securities and therefore the tax exempt investor's share of such income of the hedge fund is not UBTI and not subject to federal income tax. However, hedge funds may subject tax exempt entities to UBTI under certain circumstances where the hedge fund is borrowing or purchasing securities on margin. Such transactions may subject the tax exempt to UBTI tax.

**ULPA:** Uniform Limited Partnership Act, see also the RULPA, Revised Uniform Limited Partnership Act U.L.P.A. § 101 et seq. (1976), as amended in 1985 (R.U.L.P.A.).

**Upper quartile:** The point at which 25% of all returns in a group are greater and 75% are lower.

**- V -**

**Venture Capital Financing:** An investment in a startup business that is perceived to have excellent growth prospects but does not have access to capital markets. Type of financing sought by early-stage companies seeking to grow rapidly.

**Venture Capitalist:** A financial institution specializing in the provision of equity and other forms of long-term capital to enterprises, usually to firms with a limited track record but with the expectation of substantial growth. The venture capitalist may provide both funding and varying degrees of managerial and technical expertise.

**Vesting schedules:** Timetables for stock grants and options mandating that entrepreneurs earn (vest) their equity stakes over a number of years, rather than upon conversion of the stock options. This guarantees to investors and the market that the entrepreneurs will stick around, rather than converting and cashing in their shares.

**Vintage Year:** The year in which the venture firm began making investments. Often, those funds with "vintage years" at the top of the market will have lower than average returns because portfolio company valuations were high, e.g an Internet Fund started in vintage year 1998.

**Voluntary Redemption:** is the right of a company to repurchase some or all of an investors' outstanding shares at a stated price at a given time in the future. The purchase price is usually the Issue Price, increased by Cumulative Dividends.

**Voting Right:** The common stockholders' right to vote their stock in the affairs of the company. Preferred stock usually has the right to vote when preferred dividends are in default for a specified amount of time. The right to vote may be delegated by the stockholder to another person.

**- W -**

**Warrant:** A type of security that entitles the holder to buy a proportionate amount of common stock or preferred stock at a specified price for a period of years. Warrants are usually issued together with a loan, a bond or preferred stock --and act as sweeteners, to enhance the marketability of the accompanying securities. They are also known as stock-purchase warrants and subscription warrants.

**Wash-Out Round:** A financing round whereby previous investors, the founders, and management suffer significant dilution. Usually as a result of a washout round, the new investor gains majority ownership and control of the company. Also known as burn-out or cram-down rounds.

**Weighted Average Antidilution:** The investor's conversion price is reduced, and thus the number of common shares received on conversion increased, in the case of a down round; it takes into account both: (a) the reduced price and, (b) how many shares (or rights) are issued in the dilutive financing. See Broad-Based Ratchet and Narrow-Based Ratchet definitions.

**Williams Act of 1968:** An amendment of the [Securities and Exchange Act of 1934](#) that regulates tender offers and other takeover related actions such as larger share purchases.

**Workout:** A negotiated agreement between the debtors and its creditors outside the bankruptcy process.

**Write-off:** The act of changing the value of an asset to an expense or a loss. A write-off is used to reduce or eliminate the value an asset and reduce profits.

**Write-up/Write-down:** An upward or downward adjustment of the value of an asset for accounting and reporting purposes. These adjustments are estimates and tend to be subjective; although they are usually based on events affecting the investee company or its securities beneficially or detrimentally.