

What happens to potential venture capital transactions when the lead venture fund investor and the target company agree that they want to move forward to a term sheet but cannot agree on a pre-money valuation for the company? This scenario has become more commonplace as the IPO market has re-opened to venture-backed companies. Increases in public market indices since 2002 have trickled down to the private company market. According to the Money Tree Survey, average post-money valuations for transactions closed during the 12 months ended Q3 2004 rose to \$70.2 million, compared with \$65.4 million for the prior year, a 7% increase.

The resulting increasing valuations have led to greater disagreements between venture funds and companies on valuation. At an anecdotal level, our Firm has been engaged in transactions where entrepreneurs are freshly emboldened by recent positive IPO and M&A exits by venture-backed companies. Meanwhile, venture funds continue to resist increases in valuation after the sharp reversals suffered in down rounds after the Internet bubble bust.

One tool for bridging the valuation gap is “exploding warrants.” These warrants are issued to the venture investor, often exercisable for the same participating preferred stock in which the fund is investing with an exercise price equal to the price per share of the preferred stock being issued by the company. Unlike typical warrants issued to give investors warrant coverage, exploding warrants only become exercisable if the issuing company fails to meet certain milestones. These milestones can be sales or revenue-based targets, EBITDA thresholds, or defined product goals. If the goals are met, the warrants terminate, or “explode.”

For example, suppose a venture investor proposes to invest \$2 million in a target company placing a post-money valuation on the company of \$6 million. The company’s management in our example believes that the company’s post-money valuation should be \$10 million given its projected sales over the next 12 months. The professionals at the venture fund might agree with the company’s assessment, if in fact the sales forecast were to prove accurate. Exploding warrants are useful in bridging divides such as this.

The company would issue enough preferred stock and exploding warrants so that if the warrants become exercisable because the sales target was not met, the company would have had a \$6 million post-money valuation at the time of the investment. Conversely, should the company’s sales target be met, the warrants “explode” thereby reducing enough outstanding equity securities so that post-money valuation of the company would have been \$10 million.

For more information on exploding warrants, please contact Ed Reitler at 212.209.3010 or email at ereitler@reitlerbrown.com.