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Private Equity Glossary

“A” round – a financing event whereby angel groups and / or venture capitalists become involved in a fast growth company that was previously financed by founders and their friends and families.

Accredited investor – a person or legal entity, such as a company or trust fund, that meets certain net worth and income qualifications and is considered to be sufficiently sophisticated to make investment decisions in complex situations. Regulation D of the Securities Act of 1933 exempts accredited investors from protection under the Securities Act. Qualifications for a person are: \$1 million net worth or annual income exceeding \$200,000 individually or \$300,000 with a spouse. Directors and executive officers are considered to be accredited investors.

After-tax operating income – see **Net operating profit after taxes**.

Airball – a loan whose value exceeds the value of the collateral.

Alternative asset class – a class of investments that includes private equity, hedge funds, real estate, and oil and gas, but excludes publicly traded securities. Pension plans, college endowments and other relatively large institutional investors typically allocate a certain percentage of their investments to alternative assets with an objective to diversify their portfolios.

This document was written by Adjunct Associate Professor Fred Wainwright and Professor Colin Blaydon of the Tuck School of Business at Dartmouth College. Jesse Sherman T'05 provided assistance with an update. It was written as a basis for class discussion and not to illustrate effective or ineffective management practices.

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Alpha – a term derived from statistics and finance theory that is used to describe the return produced by a fund manager in excess of the return of a benchmark index. Manager returns and benchmark returns are measured net of the risk-free rate. In addition, manager returns are adjusted for the risk of the manager’s portfolio relative to the risk of the benchmark index. Alpha is a proxy for manager skill.

Angel – a wealthy individual that invests in companies in relatively early stages of development. Usually angels invest less than \$1 million per startup.

Anti-dilution – a contract clause that protects an investor from a substantial reduction in percentage ownership in a company due to the issuance by the company of additional shares to other entities. The mechanism for making adjustments is called a **Ratchet**.

“B” round – a financing event whereby investors such as venture capitalists and organized angel groups 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.

Balloon payment – a relatively large principal payment due at a specific time as required by a lender.

Basis point (“bp”) – one one-hundredth (1/100) of a percentage unit. For example, 50 basis points equals one half of one percent. Banks quote variable loan rates in terms of an index plus a margin and the margin is often described in basis points, such as LIBOR plus 400 basis points (or, as the experts say, “beeps”).

Best efforts offering – a commitment by a syndicate of investment banks to use best efforts to ensure the sale to investors of a company’s offering of securities. In a best efforts offering, the syndicate avoids any firm commitment for a specific number of shares or bonds.

Beta – a measure of volatility of a public stock relative to an index or a composite of all stocks in a market or geographical region. A beta of more than one indicates the stock has higher volatility than the index (or composite) and a beta of one indicates volatility equivalent to the index (or composite). For example, the price of a stock with a beta of 1.5 will change by 1.5% if the index value changes by 1%. Typically, the S&P500 index is used in calculating the beta of a stock.

Beta Product – a product that is being tested by potential customers prior to being formally launched into the marketplace.

Blow-out round – see **Cram-down round**.

Blue sky – regulations in individual states regarding the sale of securities and mutual funds. These laws are intended to protect investors from purposely fraudulent transactions.

Board of directors – a group of individuals, typically composed of managers, investors and experts who have a fiduciary responsibility for the well being and proper guidance of a corporation. The board is elected by the shareholders.

Boat anchor – a person, project or activity that hinders the growth of a company.

Book – see **Private placement memorandum**.

Book runner – the lead bank that manages the transaction process for an equity or debt financing, including documentation, syndication, pricing, allocation and closing.

Book value – the book value of a company is the value of the common stock as shown on its balance sheet. This is defined as total assets minus liabilities minus preferred stock minus intangible assets. The book value of an asset of a company is typically based on its original cost minus accumulated depreciation.

Bootstrapping – the actions of a startup to minimize expenses and build cash flow, thereby reducing or eliminating the need for outside investors.

Bp – see **Basis point**.

Bridge financing – temporary funding that will eventually be replaced by permanent capital from equity investors or debt lenders. In venture capital, a bridge is usually a short term note (6 to 12 months) that converts to preferred stock. Typically, the bridge lender has the right to convert the note to preferred stock at a price that is a 20% to 25% discount from the price of the preferred stock in the next financing round. See **Mezzanine** and **Wipeout bridge**.

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 weighted 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. See **Narrow-based weighted average ratchet**.

Bullet payment – a payment of all principal due at a time specified by a bank or a bond issuer.

Burn rate – the rate at which a startup with little or no revenue uses available cash to cover expenses. Usually expressed on a monthly or weekly basis.

Business Development Company (BDC) – a publicly traded company that invests in private companies and is required by law to provide meaningful support and assistance to its portfolio companies.

Business plan – a document that describes a new concept for a business opportunity. A business plan typically includes the following sections: executive summary, market need, solution, technology, competition, marketing, management, operations and financials.

Buyout – a sector of the private equity industry. Also, the purchase of a controlling interest of a company by an outside investor (in a leveraged buyout) or a management team (in a management buyout).

Buy-sell agreement – a contract that sets forth the conditions under which a shareholder must first offer his or her shares for sale to the other shareholders before being allowed to sell to entities outside the company.

C Corporation – an ownership structure that allows any number of individuals or companies to own shares. A C corporation is a stand-alone legal entity so it offers some protection to its owners, managers and investors from liability resulting from its actions.

Call date – when a bond issuer has the right to retire part or all of a bond issuance at a specific price.

Call premium – the premium above par value that an issuer is willing to pay as part of the redemption of a bond issue prior to maturity.

Call price – the price an issuer agrees to pay to bondholders to redeem all or part of a bond issuance.

Call protection – a provision in the terms of a bond specifying the period of time during which the bond cannot be called by the issuer.

Capital Asset Pricing Model (CAPM) – a method of estimating the cost of equity capital of a company. The cost of equity capital is equal to the return of a risk-free investment plus a premium that reflects the risk of the company's equity.

Capital call – when a private equity fund manager (usually a “general partner” in a partnership) requests that an investor in the fund (a “limited partner”) provide additional capital. Usually a limited partner will agree to a maximum investment amount and the general partner will make a series of capital calls over time to the limited partner as opportunities arise to finance startups and buyouts.

Capital gap - the difficulty faced by some entrepreneurs in trying to raise between \$2 million and \$5 million. Friends, family and angel investors are typically good sources for financing rounds of less than \$2 million, while many venture capital funds have become so large that they are only interested in investing amounts greater than \$5 million.

Capitalization table – a table showing the owners of a company's shares and their ownership percentages as well as the debt holders. It also lists the forms of ownership, such as common stock, preferred stock, warrants, options, senior debt, and subordinated debt.

Capital gains – a tax classification of investment earnings resulting from the purchase and sale of assets. Typically, an investor prefers that investment earnings be classified as long term capital gains (held for a year or longer), which are taxed at a lower rate than ordinary income.

Capital stock – a description of stock that applies when there is only one class of shares. This class is known as “common stock”.

Capped participating preferred stock – preferred stock whose participating feature is limited so that an investor cannot receive more than a specified amount. See **Participating preferred stock**.

Carried interest – a share in the profits of a private equity fund. Typically, a fund must return the capital given to it by limited partners plus any preferential rate of return before the general partner can share in the profits of the fund. The general partner will then receive a 20% carried interest, although some successful firms receive 25%-30%. Also known as “carry” or “promote.”

Catch-up – a clause in the agreement between the general partner and the limited partners of a private equity fund. Once the limited partners have received a certain

portion of their expected return, the general partner can then receive a majority of profits until the previously agreed upon profit split is reached.

Change of control bonus – a bonus of cash or stock given by private equity investors to members of a management group if they successfully negotiate a sale of the company for a price greater than a specified amount.

Clawback – a clause in the agreement between the general partner and the limited partners of a private equity fund. The clawback gives limited partners the right to reclaim a portion of disbursements to a general partner for profitable investments based on significant losses from later investments in a portfolio.

Closing – the conclusion of a financing round whereby all necessary legal documents are signed and capital has been transferred.

Club deal – see **Co-investment**.

Co-investment – either a) the right of a limited partner to invest with a general partner in portfolio companies, or b) the act of investing by two or more entities in the same target company (also known as a **Club deal**).

Collateral – hard assets of the borrower, such as real estate or equipment, for which a lender has a legal interest until a loan obligation is fully paid off.

Commitment – an obligation, typically the maximum amount that a limited partner agrees to invest in a fund.

Common stock – a type of security representing ownership rights in a company. Usually, company founders, management and employees own common stock while investors own preferred stock. In the event of a liquidation of the company, the claims of secured and unsecured creditors, bondholders and preferred stockholders take precedence over common stockholders. See **Preferred stock**.

Comparable – a publicly traded company with similar characteristics to a private company that is being valued. For example, a telecommunications equipment manufacturer whose market value is 2 times revenues can be used to estimate the value of a similar and relatively new company with a new product in the same industry. See **Liquidity discount**.

Control – the authority of an individual or entity that owns more than 50% of equity in a company or owns the largest block of shares compared to other shareholders.

Consolidation – see **Rollup**.

Conversion – the right of an investor or lender to force a company to replace the investor's preferred shares or the lender's debt with common shares at a preset conversion ratio. A conversion feature was first used in railroad bonds in the 1800's.

Convertible debt – a loan which allows the lender to exchange the debt for common shares in a company at a preset conversion ratio

Convertible preferred stock – a type of stock that gives an owner the right to convert to common shares of stock. Usually, preferred stock has certain rights that common stock doesn't have, such as decision-making management control, a promised return on investment (dividend), or senior priority in receiving proceeds from a sale or liquidation of the company. Typically, convertible preferred stock automatically converts to common stock if the company makes an initial public offering (IPO). Convertible preferred is the most common tool for private equity funds to invest in companies.

Convertible security – a security that gives its owner the right to exchange the security for common shares in a company at a preset conversion ratio. The security is typically preferred stock, warrants or debt.

Co-sale right – a contractual right of an investor to sell some of the investor's stock along with the founder's or majority shareholder's stock if either the founder or majority shareholder elects to sell stock to a third-party. Also known as **Tag-along right**.

Cost of capital – see **Weighted average cost of capital**.

Cost of revenue – the expenses generated by the core operations of a company.

Covenant – a legal promise to do or not do a certain thing. For example, in a financing arrangement, company management may agree to a negative covenant, whereby it promises not to incur additional debt. The penalties for violation of a covenant may vary from repairing the mistake to losing control of the company.

Coverage ratio – describes a company's ability to pay debt from cash flow or profits. Typical measures are EBITDA/Interest, (EBITDA minus Capital Expenditures)/Interest, and EBIT/Interest.

Cram down round – a financing event upon which new investors with substantial capital are able to demand and receive contractual terms that effectively cause the issuance of sufficient new shares by the startup company to significantly reduce (“dilute”) the ownership percentage of previous investors.

Cumulative dividends – the owner of preferred stock with cumulative dividends has the right to receive accrued (previously unpaid) dividends in full before dividends are paid to any other classes of stock.

Current ratio – the ratio of current assets to current liabilities.

Data room – a specific location where potential buyers / investors can review confidential information about a target company. This information may include detailed financial statements, client contracts, intellectual property, property leases, and compensation agreements.

Deal flow – a measure of the number of potential investments that a fund reviews in any given period.

Debt service ratio – the ratio of a required loan payment amount (“debt service”) to available cash flow earned during a specific period. Typically lenders insist that a company maintain a certain debt service ratio or else risk penalties such as having to pay off the loan immediately.

Default – a company’s failure to comply with the terms and conditions of a financing arrangement.

Defined benefit plan – a company retirement plan in which the benefits are typically based on an employee’s salary and number of years worked. Fixed benefits are paid after the employee retires. The employer bears the investment risk and is committed to providing the benefits to the employee. Defined benefit plan managers can invest in private equity funds.

Defined contribution plan – a company retirement plan in which the employee elects to contribute some portion of his or her salary into a retirement plan, such as a 401(k) or 403(b). The employer may also contribute to the employee’s plan. With this type of plan, the employee bears the investment risk. The benefits depend solely on the amount of money made from investing the employee’s contributions. Defined contribution plan capital cannot be invested in private equity funds.

Demand rights – a type of registration right. Demand rights give an investor the right to force a startup to register its shares with the SEC and prepare for a public sale of stock (IPO).

Dilution – the reduction in the ownership percentage of current investors, founders and employees caused by the issuance of new shares to new investors.

Dilution protection – see **Anti-dilution** and **Ratchet**.

Direct costs – see **Cost of revenue**.

Disbursement – an investment by a fund in a company.

Discount rate – the interest rate used to determine the present value of a series of future cash flows.

Discounted cash flow (DCF) – a valuation methodology whereby the present value of all future cash flows expected from a company is calculated.

Distressed debt – the bonds of a company that is either in or approaching bankruptcy. Some private equity funds specialize in purchasing such debt at deep discounts with the expectation of exerting influence in the restructuring of the company and then selling the debt once the company has meaningfully recovered.

Distribution – the transfer of cash or securities to a limited partner resulting from the sale, liquidation or IPO of one or more portfolio companies in which a general partner chose to invest.

Dividends – payments made by a company to the owners of certain securities. Typically, dividends are paid quarterly, by approval of the board of directors, to owners of preferred stock.

Down round – a round of financing whereby the valuation of the company is lower than the value determined by investors in an earlier round.

Drag-along rights – the contractual right of an investor in a company to force all other investors to agree to a specific action, such as the sale of the company.

Drawdown schedule – an estimate of the gradual transfer of committed investment funds from the limited partners of a private equity fund to the general partners.

Drive-by VC – a venture capitalist that only appears during board meetings of a portfolio company and rarely offers advice to management.

Due diligence – the investigatory process performed by investors to assess the viability of a potential investment and the accuracy of the information provided by the target company.

Dutch auction – a method of conducting an IPO whereby newly issued shares of stock are committed to the highest bidder, then, if any shares remain, to the next highest bidder, and so on until all the shares are committed. Note that the price per share paid by all buyers is the price commitment of the buyer of the last share.

Early stage – the state of a company after the seed (formation) stage but before middle stage (generating revenues). Typically, a company in early stage will have a core management team and a proven concept or product, but no positive cash flow.

Earnings before interest and taxes (EBIT) – a measurement of the operating profit of a company. One possible valuation methodology is based on a comparison of private and public companies' value as a multiple of EBIT.

Earnings before interest, taxes, depreciation and amortization (EBITDA) – a measurement of the cash flow of a company. One possible valuation methodology is based on a comparison of private and public companies' value as a multiple of EBITDA.

Earn out- an arrangement in which sellers of a business receive additional future payments, usually based on financial performance metrics such as revenue or net income.

Elevator pitch – a concise presentation, lasting only a few minutes (an elevator ride), by an entrepreneur to a potential investor about an investment opportunity.

Employee Stock Ownership Program (ESOP) – a plan established by a company to reserve shares for employees.

Entrepreneur – an individual who starts his or her own business.

Entrepreneurship – the application of innovative leadership to limited resources in order to create exceptional value.

Enterprise Value (EV) – the sum of the market values of the common stock and long term debt of a company, minus excess cash.

Equity – the ownership structure of a company represented by common shares, preferred shares or unit interests. $\text{Equity} = \text{Assets} - \text{Liabilities}$.

ESOP – see **Employee Stock Ownership Program**.

Evergreen fund – a fund that reinvests its profits in order to ensure the availability of capital for future investments.

Exit strategy – the plan for generating profits for owners and investors of a company. Typically, the options are to merge, be acquired or make an initial public offering (IPO). An alternative is to recapitalize (releverage the company and then pay dividends to shareholders).

Expansion stage – the stage of a company characterized by a complete management team and a substantial increase in revenues.

Fairness opinion – a letter issued by an investment bank that charges a fee to assess the fairness of a negotiated price for a merger or acquisition.

Firm commitment - a commitment by a syndicate of investment banks to purchase all the shares available for sale in a public offering of a company. The shares will then be resold to investors by the syndicate.

First refusal –the right of a privately owned company to purchase any shares that employees would like to sell.

Flipping – the act of selling shares immediately after an initial public offering. Investment banks that underwrite new stock issues attempt to allocate shares to new investors that indicate they will retain the shares for several months. Often management and venture investors are prohibited from selling IPO shares until a “lock-up period” (usually 6 to 12 months) has expired.

Founder – a person who participates in the creation of a company. Typically, founders manage the company until it has enough capital to hire professional managers.

Founders stock – nominally priced common stock issued to founders, officers, employees, directors, and consultants.

Free cash flow to equity (FCFE) – the cash flow available after operating expenses, interest payments on debt, taxes, net principal repayments, preferred

stock dividends, reinvestment needs and changes in working capital. In a discounted cash flow model to determine the value of the equity of a firm using FCFE, the discount rate used is the cost of equity.

Free cash flow to the firm (FCFF) – the operating cash flow available after operating expenses, taxes, reinvestment needs and changes in working capital, but before any interest payments on debt are made. In a discounted cash flow model to determine the enterprise value of a firm using FCFF, the discount rate used is the weighted average cost of capital (WACC).

Friends and family financing – capital provided by the friends and family of founders of an early stage company. Founders should be careful not to create an ownership structure that may hinder the participation of professional investors once the company begins to achieve success.

Full ratchet – an anti-dilution protection mechanism whereby the price per share of the preferred stock of investor A is adjusted downward 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 match the price of investor B's preferred stock. Usually as a result of the implementation of a ratchet, company management and employees who own a fixed amount of common shares suffer significant dilution. See **Narrow-based weighted average ratchet** and **Broad-based weighted average ratchet**.

Fully diluted basis – a methodology for calculating any per share ratios whereby the denominator is the total number of shares issued by the company on the assumption that all warrants and options are exercised and preferred stock.

Fund-of-funds – a fund created to invest in private equity funds. Typically, individual investors and relatively small institutional investors participate in a fund-of-funds to minimize their portfolio management efforts.

Holding period – amount of time an investment remains in a portfolio.

Gatekeepers- intermediaries which endowments, pension funds and other institutional investors use as advisors regarding private equity investments.

General partner (GP) – a class of partner in a partnership. The general partner retains liability for the actions of the partnership. In the private equity world, the GP is the fund manager while the limited partners (LPs) are the institutional and high net worth investors in the partnership. The GP earns a management fee and a percentage of profits (see **Carried interest**).

GP – see **General partner**.

Going-private transaction – when a public company chooses to pay off all public investors, delist from all stock exchanges, and become owned by management, employees, and select private investors.

Golden handcuffs – financial incentives that discourage founders and / or important employees from leaving a company before a predetermined date or important milestone.

Grossing up – an adjustment of an option pool for management and employees of a company which increases the number of shares available over time. This usually occurs after a financing round whereby one or more investors receive a relatively large percentage of the company. Without a grossing up, managers and employees would suffer the financial and emotional consequences of dilution, thereby potentially affecting the overall performance of the company.

Growth stage – the state of a company when it has received one or more rounds of financing and is generating revenue from its product or service. Also known as “middle stage.”

Hart-Scott-Rodino Act – a law requiring entities that acquire certain amounts of stock or assets of a company to inform the Federal Trade Commission and the Department of Justice and to observe a waiting period before completing the transaction.

Harvest – to generate cash or stock from the sale or IPO of companies in a private equity portfolio of investments.

Hedge fund – an investment fund that has the ability to use leverage, take short positions in securities, or use a variety of derivative instruments in order to achieve a return that is relatively less correlated to the performance of typical indices (such as the S&P 500) than traditional long-only funds. Hedge fund managers are typically compensated based on assets under management as well as fund performance.

High yield debt – debt issued via public offering or public placement (Rule 144A) that is rated below investment grade by S&P or Moody’s. This means that the debt is rated below the top four rating categories (i.e. S&P BB+, Moody’s Ba2 or below). The lower rating is indicative of higher risk of default, and therefore the debt carries a higher coupon or yield than investment grade debt. Also referred to as **Junk bonds** or **Sub-investment grade debt**.

Hockey stick – 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.

Hot issue – stock in an initial public offering that is in high demand.

Hot money – capital from investors that have no tolerance for lack of results by the investment manager and move quickly to withdraw at the first sign of trouble.

Hurdle rate – a minimum rate of return required before an investor will make an investment.

Incorporation – the process by which a business receives a state charter, allowing it to become a corporation. Many corporations choose Delaware because its laws are business-friendly and up to date.

Incubator – a company or facility designed to host startup companies. Incubators help startups grow while controlling costs by offering networks of contacts and shared backoffice resources.

Indenture – the terms and conditions between a bond issuer and bond buyers.

Initial public offering (IPO) – the first offering of stock by a company to the public. New public offerings must be registered with the Securities and Exchange Commission. An IPO is one of the methods that a startup that has achieved significant success can use to raise additional capital for further growth. See **Qualified IPO**.

In-kind distribution – a distribution to limited partners of a private equity fund that is in the form of publicly traded shares rather than cash.

Inside round – a round of financing in which the investors are the same investors as the previous round. An inside round raises liability issues since the valuation of the company has no third party verification in the form of an outside investor. In addition, the terms of the inside round may be considered self-dealing if they are onerous to any set of shareholders or if the investors give themselves additional preferential rights.

Institutional investor – professional entities that invest capital on behalf of companies or individuals. Examples are: pension plans, insurance companies and university endowments.

Intellectual property (IP) – knowledge, techniques, writings and images that are intangible but often protected by law via patents, copyrights, and trademarks.

Interest coverage ratio – earnings before interest and taxes (EBIT) divided by interest expense. This is a key ratio used by lenders to assess the ability of a company to produce sufficient cash to pay its debt obligation.

Internal rate of return (IRR) – the interest rate at which a certain amount of capital today would have to be invested in order to grow to a specific value at a specific time in the future.

Investment thesis / Investment philosophy – the fundamental ideas which determine the types of investments that an investment fund will choose in order to achieve its financial goals.

IPO – see **Initial public offering**.

IRR – see **Internal rate of return**.

Issuer – the company that chooses to distribute a portion of its stock to the public.

J curve – a concept that during the first few years of a private equity fund, cash flow or returns are negative due to investments, losses, and expenses, but as investments produce results the cash flow or returns trend upward. A graph of cash flow or returns versus time would then resemble the letter “J”.

Junior debt – a loan that has a lower priority than a senior loan in case of a liquidation of the asset or borrowing company. Also known as “subordinated debt”.

Junk Bond – see **High Yield Debt**.

Later stage – the state of a company that has proven its concept, achieved significant revenues compared to its competition, and is approaching cash flow break even or positive net income. Typically, a later stage company is about 6 to 12 months away from a liquidity event such as an IPO or buyout. The rate of return for venture capitalists that invest in later stage, less risky ventures is lower than in earlier stage ventures.

LBO – see **Leveraged buyout**.

Lead investor – the venture capital investor that makes the largest investment in a financing round and manages the documentation and closing of that round. The lead investor sets the price per share of the financing round, thereby determining the valuation of the company.

Letter of intent – a document confirming the intent of an investor to participate in a round of financing for a company. By signing this document, the subject company agrees to begin the legal and due diligence process prior to the closing of the transaction. Also known as a “Term Sheet”.

Leverage – the use of debt to acquire assets, build operations and increase revenues. By using debt, a company is attempting to achieve results faster than if it only used its cash available from pre-leverage operations. The risk is that the increase in assets and revenues does not generate sufficient net income and cash flow to pay the interest costs of the debt.

Leveraged buyout (LBO) – the purchase of a company or a business unit of a company by an outside investor using mostly borrowed capital.

Leveraged recapitalization – the reorganization of a company’s capital structure resulting in more debt added to the balance sheet. Private equity funds can recapitalize a portfolio company and then direct the company to issue a one-time dividend to equity investors. This is often done when the company is performing well financially and the debt markets are expanding.

Leverage ratios – measurements of a company’s debt as a multiple of cash flow. Typical leverage ratios include Total Debt / EBITDA, Total Debt / (EBITDA minus Capital Expenditures), and Seniore Debt / EBITDA.

L.I.B.O.R. – see **The London Interbank Offered Rate**.

License – a contract in which a patent owner grants to a company the right to make, use or sell an invention under certain circumstances and for compensation.

Limited liability company (LLC) – an ownership structure designed to limit the founders’ losses to the amount of their investment. An LLC does not pay taxes, rather its owners pay taxes on their proportion of the LLC profits at their individual tax rates.

Limited partnership – a legal entity composed of a general partner and various limited partners. The general partner manages the investments and is liable for the actions of the partnership while the limited partners are generally protected from legal actions and any losses beyond their original investment. The general partner receives a management fee and a percentage of profits (see **Carried interest**), while the limited partners receive income, capital gains and tax benefits.

Limited partner (LP) – an investor in a limited partnership. The general partner is liable for the actions of the partnership while the limited partners are generally protected from legal actions and any losses beyond their original investment. The limited partner receives income, capital gains and tax benefits.

Liquidation – the sale of a company. This may occur in the context of an acquisition by a larger company or in the context of selling off all assets prior to cessation of operations (Chapter 7 bankruptcy). In a liquidation, the claims of secured and unsecured creditors, bondholders and preferred stockholders take precedence over common stockholders.

Liquidation preference – the contractual right of an investor to priority in receiving the proceeds from the liquidation of a company. For example, a venture capital investor with a “2x liquidation preference” has the right to receive two times its original investment upon liquidation.

Liquidity discount – a decrease in the value of a private company compared to the value of a similar but publicly traded company. Since an investor in a private company cannot readily sell his or her investment, the shares in the private company must be valued less than a comparable public company.

Liquidity event – a transaction whereby owners of a significant portion of the shares of a private company sell their shares in exchange for cash or shares in another, usually larger company. For example, an IPO is a liquidity event.

Lock-up agreement – investors, management and employees often agree not to sell their shares for a specific time period after an IPO, usually 6 to 12 months. By avoiding large sales of its stock, the company has time to build interest among potential buyers of its shares.

London Interbank Offered Rate (L.I.B.O.R.) – the average rate charged by large banks in London for loans to each other. LIBOR is a relatively volatile rate and is typically quoted in maturities of one month, three months, six months and one year.

LP – see **Limited partner**.

Management buyout (MBO) – a leveraged buyout controlled by the members of the management team of a company or a division. Often an MBO is conducted in partnership with a buyout fund.

Management fee – a fee charged to the limited partners in a fund by the general partner. Management fees in a private equity fund typically range from 0.75% to 3% of capital under management, depending on the type and size of fund.

Management rights – the rights often required by a venture capitalist as part of the agreement to invest in a company. The venture capitalist has the right to consult with management on key operational issues, attend board meetings and review information about the company’s financial situation.

Market capitalization – the value of a publicly traded company as determined by multiplying the number of shares outstanding by the current price per share.

MBO – see **Management buyout**.

Mezzanine – a layer of financing that has intermediate priority (seniority) in the capital structure of a company. For example, mezzanine debt has lower priority than senior debt but usually has a higher interest rate and often includes warrants. In venture capital, a mezzanine round is generally the round of financing that is designed to help a company have enough resources to reach an IPO. See **Bridge financing**.

Middle stage – the state of a company when it has received one or more rounds of financing and is generating revenue from its product or service. Also known as “growth stage.”

Milestones – operational or financial goals of a company that are often used to determine whether a company will receive additional financing or whether management will receive additional compensation.

Multiples – a valuation methodology that compares public and private companies in terms of a ratio of value to an operations figure such as revenue or net income. For example, if several publicly traded computer hardware companies are valued at approximately 2 times revenues, then it is reasonable to assume that a startup computer hardware company that is growing fast has the potential to achieve a valuation of 2 times its revenues. Before the startup issues its IPO, it will likely be valued at less than 2 times revenue because of the lack of liquidity of its shares. See **Liquidity discount**.

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 weighted average price.

NDA – see **Non-disclosure agreement**.

Net operating income (NOI) – a measure of cash flow that excludes the effects of financing decisions. NOI is calculated as earnings before interest and taxes multiplied by one minus the tax rate. Also known as profit after taxes (NOPAT).

No-shop clause – a section of an agreement to purchase a company whereby the seller agrees not to market the company to other potential buyers for a specific time period.

Non-compete – 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.

Non-cumulative dividends – dividends that are payable to owners of preferred stock at a specific point in time only if there is sufficient cash flow available after all company expenses have been paid. If cash flow is insufficient, the owners of the preferred stock will not receive the dividends owed for that time period and will have to wait until the board of directors declares another set of dividends.

Non-interference – an agreement often signed by employees and management whereby they agree not to interfere with the company's relationships with employees, clients, suppliers and sub-contractors within a certain time period after termination of employment.

Non-solicitation – an agreement often signed by employees and management whereby they agree not to solicit other employees of the company regarding job opportunities.

Non-disclosure agreement (NDA) – an agreement issued by entrepreneurs to protect the privacy of their ideas when disclosing those ideas to third parties.

Offering memorandum – a legal document that provides details of an investment to potential investors. See **Private placement memorandum**.

OID – see **Original issue discount**.

Operating cash flow – the cash flow produced from the operation of a business, not from investing activities (such as selling assets) or financing activities (such as issuing debt). Calculated as net operating income (NOI) plus depreciation.

Optics – the way a concept is presented. Sometimes entrepreneurs' presentations are strong on optics but weak in content.

Options – see **Stock options**.

Option pool – a group of options set aside for long term, phased compensation to management and employees.

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.

Orphan – a startup company that does not have a venture capitalist as an investor.

Outstanding shares – the total amount of common shares of a company, not including treasury stock, convertible preferred stock, warrants and options.

Oversubscription – when demand exceeds supply for shares of an IPO or a private placement.

Patent – a legal right to sue any person or company that attempts to use, manufacture or sell the patented product or process. Patents typically have a 20 year term.

Pay to play – a clause in a financing agreement whereby any investor that does not participate in a future round agrees to suffer significant dilution compared to other

investors. The most onerous version of “pay to play” is automatic conversion to common shares, which in essence ends any preferential rights of an investor, such as the right to influence key management decisions.

Pari passu – a legal term referring to the equal treatment of two or more parties in an agreement. For example, a venture capitalist may agree to have registration rights that are pari passu with the other investors in a financing round.

Participating dividends – the right of holders of certain preferred stock to receive dividends and participate in additional distributions of cash, stock or other assets.

Participating preferred stock – a unit of ownership composed of preferred stock and common stock. 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. Participating preferred stock has been characterized as “having your cake and eating it too.”

PE ratio – see **Price earnings ratio**.

PEIGG – acronym for Private Equity Industry Guidelines Group, an ad hoc group of individuals and firms involved in the private equity industry for the purpose of establishing valuation and reporting guidelines.

Piggyback rights – rights of an investor to have his or her shares included in a registration of a startup’s shares in preparation for an IPO.

PIPEs – see **Private investment in public equities**.

Placement agent – a company that specializes in finding institutional investors that are willing and able to invest in a private equity fund. Sometimes a private equity fund will hire a placement agent so the fund partners can focus on making and managing investments in companies rather than on raising capital.

Portfolio company – a company that has received an investment from a private equity fund.

Post-money valuation – the valuation of a company including the capital provided by the current round of financing. For example, a venture capitalist may invest \$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 \$7 million.

PPM – see **Private placement memorandum**.

Preemptive rights – the rights of shareholders to maintain their percentage ownership of a company by buying shares sold by the company in future financing rounds.

Preference – seniority, usually with respect to dividends and proceeds from a sale or dissolution of a company.

Preferred return – a minimum return per annum that must be generated for limited partners of a private equity fund before the general partner can begin receiving a percentage of profits from investments.

Preferred stock – a type of stock that has certain rights that common stock does not have. These special rights may include dividends, participation, liquidity preference, anti-dilution protection and veto provisions, among others. Private equity investors usually purchase preferred stock when they make investments in companies.

Pre-money valuation – the valuation of a company prior to the current round of financing. For example, a venture capitalist may invest \$5 million in a company valued at \$2 million pre-money. As a result, the startup will have a “post-money” valuation of \$7 million.

Price earnings ratio (PE ratio) – the ratio of a public company’s price per share and its net income after taxes on a per share basis.

Primary shares – shares sold by a corporation (not by individual shareholders).

Private equity – equity investments in non-public companies.

Private investment in public equities (PIPE) – investments by a private equity fund in a publicly traded company, usually at a discount and in the form of preferred stock.

Private placement – the sale of a security directly to a limited number of institutional and qualified individual investors. If structured correctly, a private placement avoids registration with the Securities and Exchange Commission.

Private placement memorandum (PPM) – a document explaining the details of an investment to potential investors. For example, a private equity fund will issue a

PPM when it is raising capital from institutional investors. Also, a startup may issue a PPM when it needs growth capital. Also known as “Offering Memorandum.”

Private securities – securities that are not registered with the Securities and Exchange Commission and do not trade on any exchanges. The price per share is negotiated between the buyer and the seller (the “issuer”).

Promote – see **Carried interest**.

Prospectus – a formal document that gives sufficient detail about a business opportunity for a prospective investor to make a decision. A prospectus must disclose any material risks and be filed with the Securities and Exchange Commission.

Prudent man rule – a fundamental principle for professional money management which serves as a basis for the Prudent Investor Act. The principle is based on a statement by Judge Samuel Putnum in 1830: “Those with the responsibility to invest money for others should act with prudence, discretion, intelligence and regard for the safety of capital as well as income.”

Purchase method – a merger accounting treatment whereby a buyer purchases the assets (and liability obligations) of a company at their market price and then records the difference between the purchase price and the book value of the assets as goodwill. This goodwill need not be amortized but must be valued annually and any decreases or increases in value must be reflected in the buyer’s financial statements.

Qualified IPO – a public offering of securities valued at or above a total amount specified in a financing agreement. This amount is usually specified to be sufficiently large to guarantee that the IPO shares will trade in a major exchange (NASDAQ or New York Stock Exchange). Usually upon a qualified IPO preferred stock is forced to convert to common stock.

Quartile – one fourth of the data points in a data set. Often, private equity investors are measured by the results of their investments during a particular period of time. Institutional investors often prefer to invest in private equity funds that demonstrate consistent results over time, placing in the upper quartile of the investment results for all funds.

Ratchet – a mechanism to prevent dilution. An anti-dilution clause is a contract clause that protects an investor from a reduction in percentage ownership in a company due to the future issuance by the company of additional shares to other entities.

Realization ratio – the ratio of cumulative distributions to paid-in capital. The realization ratio is used as a measure of the distributions from investment results of a private equity partnership compared to the capital under management.

Recapitalization – the reorganization of a company’s capital structure.

Red herring – a preliminary prospectus filed with the Securities and Exchange Commission and containing the details of an IPO offering. The name refers to the disclosure warning printed in red letters on the cover of each preliminary prospectus advising potential investors of the risks involved.

Redeemable preferred – preferred stock that can be redeemed by the owner (usually a venture capital investor) in exchange for a specific sum of money.

Redemption rights – the right of an investor to force the startup company to buy back the shares issued as a result of the investment. In effect, the investor has the right to take back his/her investment and may even negotiate a right to receive an additional sum in excess of the original investment.

Registration – the process whereby shares of a company are registered with the Securities and Exchange Commission under the Securities Act of 1933 in preparation for a sale of the shares to the public.

Registration rights – the rights of an investor in a startup regarding the registration of a portion of the startup’s shares for sale to the public. Piggyback rights give the shareholders the right to have their shares included in a registration. Demand rights give the shareholders the option to force management to register the company’s shares for a public offering. Often, registration rights are hotly negotiated among venture capitalists in multiple rounds of financing.

Regulation D – an SEC regulation that governs private placements. Private placements are investment offerings for institutional and accredited individual investors but not for the general public. There is an exception that 35 non-accredited investors can participate.

Restricted shares – shares that cannot be traded in the public markets.

Return on investment (ROI) – the proceeds from an investment, during a specific time period, calculated as a percentage of the original investment. Also, net profit after taxes divided by average total assets.

Rights offering – an offering of stock to current shareholders that entitles them to purchase the new issue, usually at a discount.

Rights of co-sale with founders – a clause in venture capital investment agreements that allows the VC fund to sell shares at the same time that the founders of a startup chose to sell.

Right of first refusal – a contractual right to participate in a transaction. For example, a venture capitalist may participate in a first round of investment in a startup and request a right of first refusal in any following rounds of investment.

Risk-free rate – a term used in finance theory to describe the return from investing in a riskless security. In practice, this is often taken to be the return on US Treasury Bills.

Road show – presentations made in several cities to potential investors and other interested parties. For example, a company will often make a road show to generate interest among institutional investors prior to its IPO.

ROI – see **Return on investment**.

Rollup – the purchase of relatively smaller companies in a sector by a rapidly growing company in the same sector. The strategy is to create economies of scale. For example, the movie theater industry underwent significant consolidation in the 1960's and 1970's.

Round – a financing event usually involving several private equity investors.

Royalties – payments made to patent or copyright owners in exchange for the use of their intellectual property.

Rule 144 – a rule of the Securities and Exchange Commission that specifies the conditions under which the holder of shares acquired in a private transaction may sell those shares in the public markets.

S corporation – an ownership structure that limits its number of owners to 100. An S corporation does not pay taxes, rather its owners pay taxes on their proportion of the corporation's profits at their individual tax rates.

SBIC – see **Small Business Investment Company**.

Scalability – a characteristic of a new business concept that entails the growth of sales and revenues with a much slower growth of organizational complexity and expenses. Venture capitalists look for scalability in the startups they select to finance.

Scale-down – a schedule for phased decreases in management fees for general partners in a limited partnership as the fund reduces its investment activities toward the end of its term.

Scale-up – the process of a company growing quickly while maintaining operational and financial controls in place. Also, a schedule for phased increases in management fees for general partners in a limited partnership as the fund increases its investment activities over time.

Search fund – an investment fund whereby one or two individuals raise sufficient capital to pay for their salary and expenses for a one to two year period in searching for a target company to acquire. Once the target is identified and a purchase agreement is signed, the individuals seek another round of funding from current and additional investors in order to purchase the target (usually using leverage).

SEC – see **Securities and Exchange Commission**.

Secondary market – a market for the sale of limited 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 shares – shares sold by a shareholder (not by the corporation).

Secured debt – debt that has seniority in case the borrowing company defaults or is dissolved and its assets sold to pay creditors.

Security – a document that represents an interest in a company. Shares of stock, notes and bonds are examples of securities.

Securities and Exchange Commission (SEC) – the regulatory body that enforces federal securities laws such as the Securities Act of 1933 and the Securities Exchange Act of 1934.

Seed capital – investment provided by angels, friends and family to the founders of a startup in seed stage.

Seed stage – the state of a company when it has just been incorporated and its founders are developing their product or service.

Senior debt – a loan that has a higher priority in case of a liquidation of the asset or company.

Seniority – higher priority.

Series A preferred stock – preferred stock issued by a fast growth company in exchange for capital from investors in the “A” round of financing. This preferred stock is usually convertible to common shares upon the IPO or sale of the company.

Sharpe Ratio – a method of calculating the risk-adjusted return of an investment. The Sharpe Ratio is calculated by subtracting the risk-free rate from the return on a specific investment for a time period (usually one year) and then dividing the resulting figure by the standard deviation of the historical (annual) returns for that investment. The higher the Sharpe Ratio, the better.

Small Business Investment Company (SBIC) – a company licensed by the Small Business Administration to receive government capital in the form of debt or equity in order to use in private equity investing.

Spin out – a division of an established company that becomes an independent entity. Also known as a spin-off.

Stock – a share of ownership in a corporation.

Stock option – a right to purchase or sell a share of stock at a specific price within a specific period of time. Stock purchase options are commonly used as long term incentive compensation for employees and management of fast growth companies.

Strategic investor – a relatively large corporation that agrees to invest in a young company in order to have access to a proprietary technology, product or service. By having this access, the corporation can potentially achieve its strategic goals.

Subordinated debt – a loan that has a lower priority than a senior loan in case of a liquidation of the asset or company. Also known as “junior debt”.

Sweat equity – ownership of shares in a company resulting from work rather than investment of capital.

Syndicate – a group of investors that agree to participate in a round of funding for a company. Alternatively, a syndicate can refer to a group of investment banks that agree to participate in the sale of stock to the public as part of an IPO.

Syndication – the process of arranging a syndicate.

Tag-along right – the right of a minority investor to receive the same benefits as a majority investor. Usually applies to a sale of securities by investors. Also known as **Co-sale right**.

Takedown – a schedule of the transfer of capital in phases in order to complete a commitment of funds. Typically, a takedown is used by a general partner of a private equity fund to plan the transfer of capital from the limited partners.

Takeover – the transfer of control of a company.

Ten bagger – an investment that returns 10 times the initial capital.

Tender offer – an offer to public shareholders of a company to purchase their shares.

Term loan – a bank loan for a specific period of time, usually up to ten years in leveraged buyout structures.

Term sheet – a document confirming the intent of an investor to participate in a round of financing for a company. By signing this document, the subject company agrees to begin the legal and due diligence process prior to the closing of the transaction. Also known as “Letter of Intent”.

Trade secret – something that is not generally known, is kept in secrecy and gives its owners a competitive business advantage.

Tranche – a portion of a set of securities. Each tranche may have different rights or risk characteristics.

Turnaround – a process resulting in a substantial increase in a company’s revenues, profits and reputation.

Two x – an expression referring to 2 times the original amount. For example, a preferred stock may have a “two x” liquidation preference, so in case of liquidation of the company, the preferred stock investor would receive twice his or her original investment.

Under water option – an option is said to be under water if the current fair market value of a stock is less than the option exercise price.

Underwriter – an investment bank that chooses to be responsible for the process of selling new securities to the public. An underwriter usually chooses to work with a syndicate of investment banks in order to maximize the distribution of the securities.

Unsecured debt – debt which does not have any priority in case of dissolution of the company and sale of its assets.

Venture capital – a segment of the private equity industry which focuses on investing in new companies with high growth rates.

Venture capital method – a valuation method whereby an estimate of the future value of a company is discounted by a certain interest rate and adjusted for future anticipated dilution in order to determine the current value. Usually, discount rates for the venture capital method are considerably higher than public stock return rates, representing the fact that venture capitalists must achieve significant returns on investment in order to compensate for the risks they take in funding unproven companies.

Vesting – a schedule by which employees gain ownership over time of a previously agreed upon amount of retirement funding or stock options.

Vintage – the year that a private equity fund stops accepting new investors and begins to make investments on behalf of those investors.

Voting rights – the rights of holders of preferred and common stock in a company to vote on certain acts affecting the company. These matters may include payment of dividends, issuance of a new class of stock, merger or liquidation.

Warrant – a security which gives the holder the right to purchase shares in a company at a pre-determined price. A warrant is a long term option, usually valid for several years or indefinitely. Typically, warrants are issued concurrently with preferred stocks or bonds in order to increase the appeal of the stocks or bonds to potential investors.

Washout 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.

Weighted average cost of capital (WACC) – the average of the cost of equity and the after-tax cost of debt. This average is determined using weight factors based on the ratio of equity to debt plus equity and the ratio of debt to debt plus equity.

Weighted average ratchet – an anti-dilution protection mechanism whereby the conversion rate of preferred stock is adjusted in order to reduce an investor’s loss due to an increase in the number of shares in a company. Without a ratchet, an investor would suffer from a dilution of his or her percentage ownership. Usually as a result of the implementation of a weighted average ratchet, company management and employees who own a fixed amount of common shares suffer significant dilution, but not as badly as in the case of a full ratchet.

Wipeout round – see **Washout round**.

Wipeout bridge – a short term financing that has onerous features whereby if the company does not secure additional long term financing within a certain time frame, the bridge investor gains ownership control of the company. See **Bridge financing**.

Write-down – a decrease in the reported value of an asset or a company.

Write-off – a decrease in the reported value of an asset or a company to zero.

Write-up – an increase in the reported value of an asset or a company.

Zombie – a company that has received capital from investors but has only generated sufficient revenues and cash flow to maintain its operations without significant growth. Typically, a venture capitalist has to make a difficult decision as to whether to kill off a zombie or continue to invest funds in the hopes that the zombie will become a winner.