TI:GER: Terms and Term Sheets

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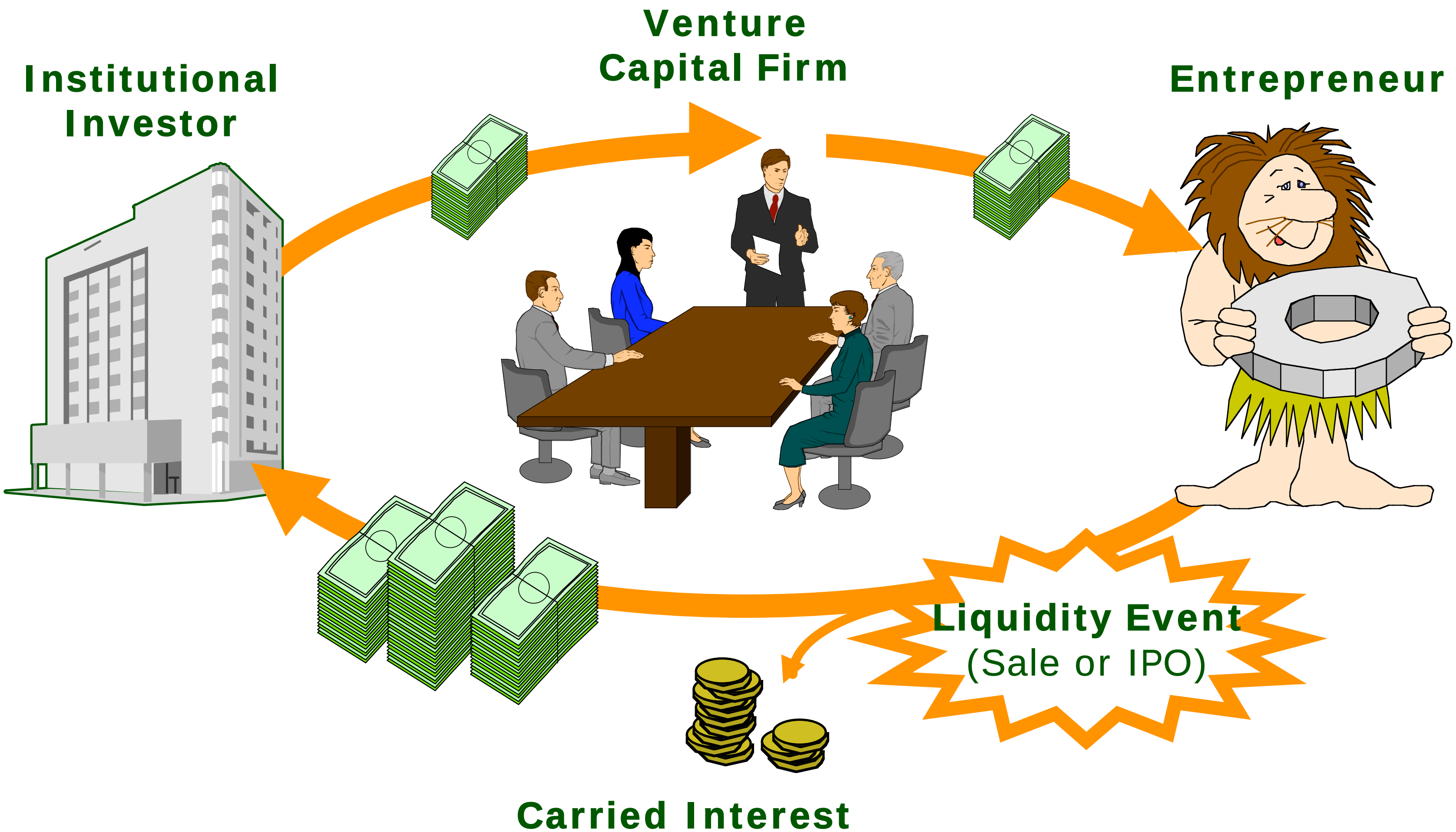
Venture Capital Cycle



Private Equity Transactions

- Sale of private securities.
  - Preferred or Common stock.
- Term sheet vs. purchase agreement.
  - Importance of good legal counsel.
- Terms accommodate two key issues:
  - Risk *(fear)*
  - Reward *(greed)*
- Most terms are standard, but some can be negotiated.

Multiple Rounds of Financing

- Most companies sell equity more than once:
  - Seed / incubation stage
    - *May be based on founder's capital instead*
  - Startup / Early-stage / First round / Series A
  - Later-stage / Second, third, etc. / Series B, C, etc.
  - Expansion / mezzanine
  - Initial public offering (IPO)

Multiple Rounds of Financing

- How much to raise?
  - Milestones?
  - Capital required?
  - Burn rate at milestone completion?
  - Sensitivity?
- Choose your investor(s)
  - Selection process is two-way!
  - Experience, knowledge, contacts.
  - Chemistry.

How Much Money to Raise?

- Equity is expensive!
- Raise as much as you need:
  - –No more ...Needless dilution of your stake
  - –No less ...Endless cycle of fundraising

▶ *Right answer:* Estimate the dollars needed to reach your next milestone of value. Then double it.

Multiple Rounds of Financing

- Typically, each round has a new “lead” investor
  - Sets the price.
  - Sets the terms.
- Exceptions:
  - Single-investor through entire life of company *(common in 1999-2000).*
  - Insider round with existing investors.
  - New investors choose to be passive.

The Term Sheet

- Lead investor prepares term sheet.
- Short document proposing an investment in the company:
  - Almost always Convertible Preferred Stock
  - Almost always a “C” corporation in a friendly stage (Delaware or equivalent)
  - Anything else is just too hard.
- Term sheet is written in a language approximating English. Negotiate *now*, not after document prep!

Term Sheet Basics

- Three terms that entrepreneurs always focus on:
  - –What’s the price?
  - –What’s the vesting schedule?
  - –Who’s in control?
- Don’t be shortsighted...

Term Sheet Complications

- Accumulated scar tissue.
  - Plan for success, but prepare for failure.
  - Many terms do not kick in for successful companies:
    - Redemption
    - Dividends
    - Anti-dilution
    - Liquidation preference
    - Right of co-sale
    - Key-man insurance

Basic Economics

- What percentage of the company will be sold, for how much money?
  - –Pre- and post-money valuations.
- Post-money capitalization percentages:
  - –Founders
  - –Employees
  - –Previous investors
  - –New investor(s)
    - Term sheet will normally guarantee a minimum amount for lead; others will commit after acceptance of terms, but before closing.

Contingencies

- Term sheets are normally contingent:
  - Finding additional investors.
  - Successful due diligence.
    - That can mean *anything!*
  - Other requirements (exec. search, etc.)
- The investor can back out at any time up to the closing date...
  - Impossible to enforce compliance.
  - Entrepreneur should insist on an expiration date after which "no shop" provisions expire.

More Terms

- Dividends
- Liquidation preferences
- Antidilution
- Voting rights
- Covenants
- Board representation
- Conversion

Dividends

- Always listed in term sheet.
- Seldom actually paid.
  - Company doesn't have spare cash.
  - Tax problems.
- Dividend provision helps distinguise Common and Preferred stock.
- Theoretically, can be a mechanism to get money out of "walking dead" company... difficult in practice.

Liquidation Preference

- Upon sale (not IPO) of company, investor can “double-dip”
  - Return of invested capital *first*, then pro rata share of remaining proceeds.
- Since the Bubble burst, some firms insist on multiple liquidation preferences (2X, 3X... even 5X).
  - *Very* entrepreneur-hostile.
- Multiple rounds will mean multiple layers of preference... *ouch!*

Liquidation Preference

- *Example:* Invest $1 million for 20% of company with 3X liquidation pref.
  - –Post-money valuation: $5 million.
- Sell company later for $20M.
  - –Investor receives 3X preference: $3 million
  - –Then receives 20% of remaining $17M: $3.4 million
- *Net:* investor receives $6.4M, or 32% of proceeds, while owning 20% of equity.
  - –Equivalent to setting initial valuation at $3.1 million instead of $5 million!

Liquidation Preference

- *Initial Public Offering (IPO):* Everyone converts to Common stock. Liquidation preferences don't matter.
- *Trade sale (M&A):* Liquidation preferences matter a lot!
- *Redemption:* Investor stock is repurchased. Preferences don't matter.
- *Bankruptcy:* Stock is worthless. Preferences don't matter.

Antidilution

- Protects investor against subsequent "down rounds"
- Two forms:
  - Full-ratchet
    - Theoretically best for investor.
    - In practice, can destroy the company.
  - Weighted average
    - Proportional to amounts invested.
    - Preserves investor's economic interest.
    - Additional equity is carved out of junior securities *(including employees and founders).*

Voting Rights

- Shares may vote “as converted,” by series, or “Preferred as a class.”
- Series votes give investors extraordinary power.
  - Can lead to gridlock after multiple rounds of financing.
  - Each new investor round has veto power.
- *Unwritten rule of term sheets:* once a term is included, all subsequent rounds of investors will insist on equal or better treatment!

Covenants

- Typically, company cannot take certain actions without permission of Preferred shareholders (“protective provisions”).
  - Issuance of new shares of stock.
  - Sale or merger.
  - Dividends or stock repurchase.
  - Substantial change to business.
  - Etc...

Board Representation: Investors

- Board seat(s) may be reserved for a particular investor and/or for a particular Series of Preferred stock.
  - Other seats may require investor approval as well.
  - Failure scenario: under certain circumstances, investor(s) may gain right to appoint a majority of the board.
  - Investors will sit on compensation, audit, and governance committees of the board.

Board Representation: Management

- Common shareholders should have at least one board seat… others to be negotiated.
  - Typically used as management seat(s).
  - If multiple, how are they assigned?
- Does CEO have a separate board seat?
- How is the chairman selected? Mutual consent, majority rule, or other?
  - Non-executive chairman?
  - Does chairmanship make a difference?

Conversion

- Usually, Preferred can be converted to Common at any time, at the sole discretion of the Preferred shareholder.
  - Legal requirement, but usually only exercised under esoteric conditions.
- Company can force a conversion to Common upon an IPO *(usually listed as a "Qualified IPO" raising not less than a specified dollar amount).*

Still More Terms

- Key-man insurance
- Founder's shares
  - Vesting schedule
  - Rule 83(b)
- Registration rights
- Right of first refusal
- Right of co-sale
- Employee agreements
- Information rights
- Fees, no-shop, and expiration date

Key-Man Insurance

- Payable to company in the event one or more founders die.
- You really hope to never need this one!!!

Founder's Shares

- This is how the founders make money!
- Investors will insist on a vesting schedule.
  - Typically, 25% cliff after one year; remainder in 36 equal monthly increments.
  - 100% vested after four years.
  - Exceptions for termination with cause, termination without cause, resignation, death, disability, etc., etc.
- Complex tax implications: Rule 83(b).

Registration Rights

- Horrendously complex.
- In practice, they are overriden by investment bankers at time of IPO.
- *Short form:* If the company files for an IPO, the Preferred shareholders get their shares registered.
  - Protects the investors from rogue management cashing out.
  - Never exercised, but they have to be there.

Other Sale Rights

- Right of first refusal.
  - If company issues new shares, investors have the first right to buy them.
    - Must be waived to bring in new investors.
  - If founders are selling shares, investors have the right to match third-party price.
- Right of co-sale.
  - If investors waive right of first refusal on third-party sale, investors get to sell some of their shares, too.

▶ Trying to keep transactions within the family.

Accelerated Vesting

- Shares can be considered 100% vested if the company is sold.
- Founders love it. Investors (and acquirers) hate it.
  - Loss of incentive to perform after transaction is complete.
- Sometimes, investors will compromise:
  - *Example:* CEO will have 50% accelerated vesting on change of control; other CxO level employees will have 25% acceleration.

Information Rights

- The company is not allowed to treat investors like mushrooms!
- Typically:
  - –Monthly/quarterly unaudited reports.
  - –Board report packages.
  - –Annual audited financial statement.
  - –Annual operating plan/budget.
  - –Access to corporate records.
  - –Etc.

Employee Agreements

- Stock option agreements.
  - Vesting schedules, again.
- Intellectual property agreements.
- Non-compete agreements.

- Some will cover all employees, others will cover only specified individuals.

Final Details

- Legal and consulting fees.
  - Company is usually responsible for fees.
  - Try to negotiate a cap!
- No-shop clause.
  - Company must terminate discussions with other potential investors.
- Expiration.
  - Beware the exploding term sheet!
  - Investor should offer a reasonable period (one week) for contemplation.

Conclusion

- Upon agreement to all terms, both parties sign... and it's handed over to the lawyers.
  - Diligence continues in both directions.
  - Lawyers rack up exorbitant fees.
  - Eventually (14-60 days), final purchase agreement and related documents are prepared.
- Typically several hundred pages of impenetrable prose!
- Close your eyes and sign...