Understanding Venture Capital Term Sheets

Harvard Business School Rock Center
March 4, 2014

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Introductions

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- Co-Chair of Technology Practice
- Named one of the "Top 20 Startup Lawyers in Boston," and one of "Ten Most Innovative Lawyers in America" by the ABA Journal
- Have worked on over 100 angel and venture capital financings (debt and equity) over 16 years of practice.

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What is a term sheet?

- aka- "Letter of Intent," "Memorandum of Understanding," "Agreement in Principle"
- First major step in transaction, when material terms of deal are negotiated and agreed to
  - Focus on the deal is at its maximum
  - Gives road map for lawyers to draft actual docs
- More detail generally better (especially for the company)

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Non Binding (to a point....)

- Not a binding agreement to fund
  - –Subject to actual documents, due diligence, other closing conditions (e.g. legal opinion)
  - –But practically speaking, very unusual for the actual deal to vary significantly from the term sheet
- Some provisions are usually legally binding
  - –Confidentiality (company can't disclose terms or even existence of term sheet)
  - –Exclusivity (company can't shop deal - usually 30-60 days)

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Types of Early Stage Financing Deals

- Seed Financing:
  - –Convertible Notes
  - –“Series Seed” or “Series AA” (i.e. Series A light)
- Series A
- Series B and later rounds

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What is a Convertible Note?

- First and foremost, it is debt, so it sits above any equity (stock) in the "capital stack"
- However, it also has an equity feature in that it converts upon specified events into stock of the company
- The most common conversion is upon a "qualified financing" (generally an equity financing of a certain size), but notes can also provide for conversion on other events

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When to use Convertible Notes

- In most cases, will be simpler, faster and cheaper than doing a preferred stock financing, but not always
- Generally speaking
  - $500k or less, use convertible notes
  - $1m or more, use preferred stock (even if “seed preferred”)
  - But there are exceptions to both of these
- Consider your future financing needs:
  - If you may never need to raise more money, do a stock deal or build in an automatic (or optional) conversion of the notes at maturity
- Consider if you are able to value the stock:
  - Often convertible notes are a way to treat friends and family money fairly by deferring a valuation until “sophisticated investors” can negotiate with the company

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Series A

- Takes the form of “Convertible Preferred Stock” with lots of contractual protections and benefits
- Economic issues:
  - Make sure you understand how the economics work and are not comparing apples to oranges
- Control issues:
  - Voting control, board seats, veto powers, forced sale

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Convertible Preferred Stock

- Why Convertible Preferred Stock?
  - "Stock" – equity ownership (junior to debt)
  - "Common Stock" – basic unit of equity ownership; issued to founders/employees/consultants.
  - "Preferred" - Preference over common stock on dividends, distributions, liquidation, redemption
  - "Convertible" – Convertible into common stock, with all the upside of common stock

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Pre-Money Valuation

- If the money I'm investing is buying me shares, then exactly how many shares do I get, and what percentage of the company do those shares represent, immediately after my investment?

- Side note: Remember, the number of shares you hold only tells you half the story. Be careful of optics.
  - Compare Warren Buffet's 350,000 shares of Berkshire Hathaway (33.1% of 1,060,000 total shares) with 350,000 shares of Google Inc. (0.1% of 324,890,000 total shares)

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Pre-Money/Post-Money

- "Pre-Money Valuation" = imputed dollar value given to the company before the new money is invested

- "Post-Money Valuation" = pre-money valuation + the amount invested.

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Pre-Money Valuation

- The pre-money valuation allows us to calculate the share price and the % of company being sold.

$$\textit{Price} = \frac{\textit{Pre-Money Valuation}}{\textit{Pre-Money Shares O/S}}$$

$$\textit{\% Sold} = \frac{\textit{Shares Issued}}{\textit{Post-money Shares O/S}} = \frac{\textit{New \$}}{\textit{Pre-Money + New \$}}$$

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Pre-Money Valuation

- Pop Quiz: "I'll invest $5 million at a $10 million pre money."
- Question: What percentage would the investor own <u>after</u> the investment?

  A: 33%

  B: 50%

  C: It's too late in the afternoon for a math quiz

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Pre-Money Valuation

Price = *Pre-Money Valuation* / *Pre-Money Shares Outstanding*

- "Option Pool" is critical issue
  - Options are rights to buy shares of common stock in the future at a set price. Granted to employees, consultants, advisors, board members.
  - The "pool" is the number of shares of common stock that you have reserved for options outstanding and options to be granted in the future.
  - Do we have a sufficient number of shares "reserved" to compensate and motivate existing and future employees?
  - The higher this number, the lower the share price for the investors, and thus the higher the number of shares issued for the same amount of money invested.
  - Bigger isn't always better.

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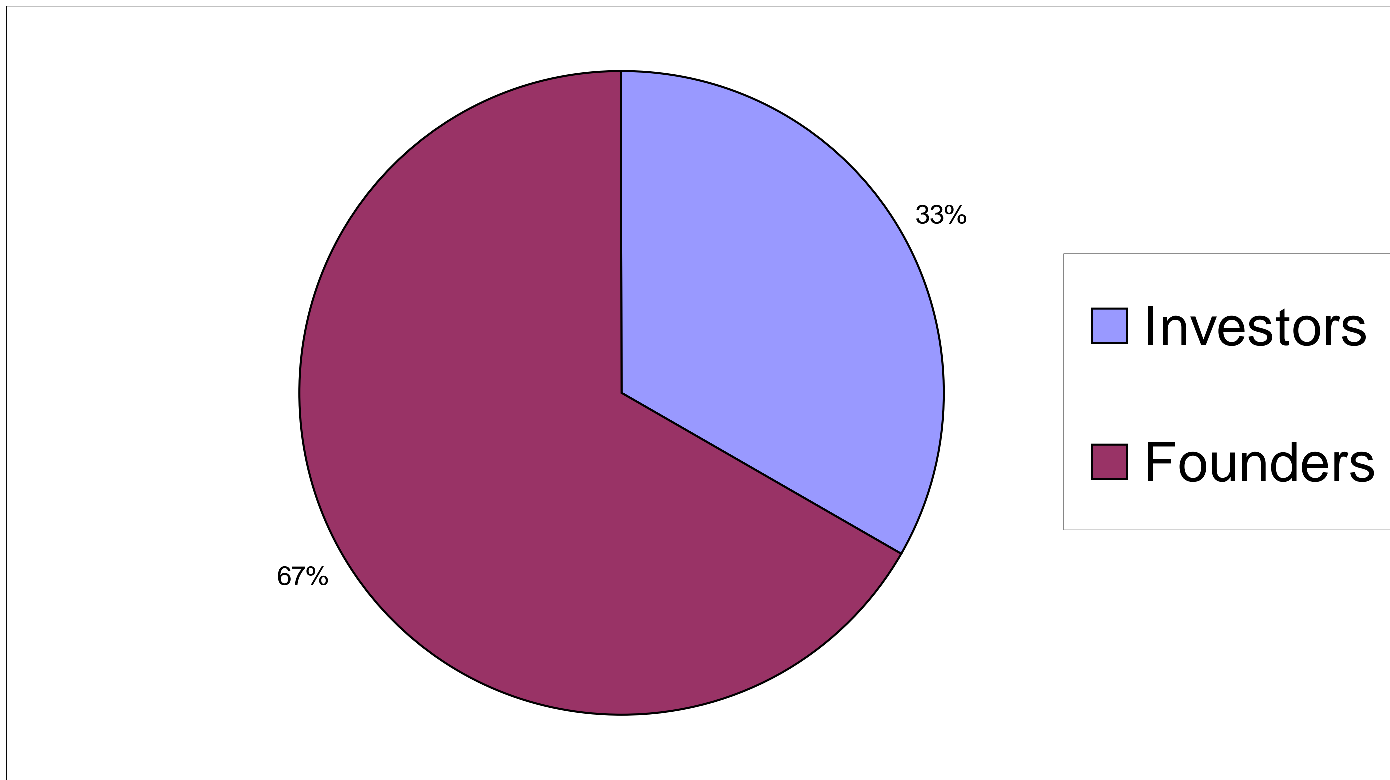
Option Pool

- Pre Money Valuation (Without Option Pool)



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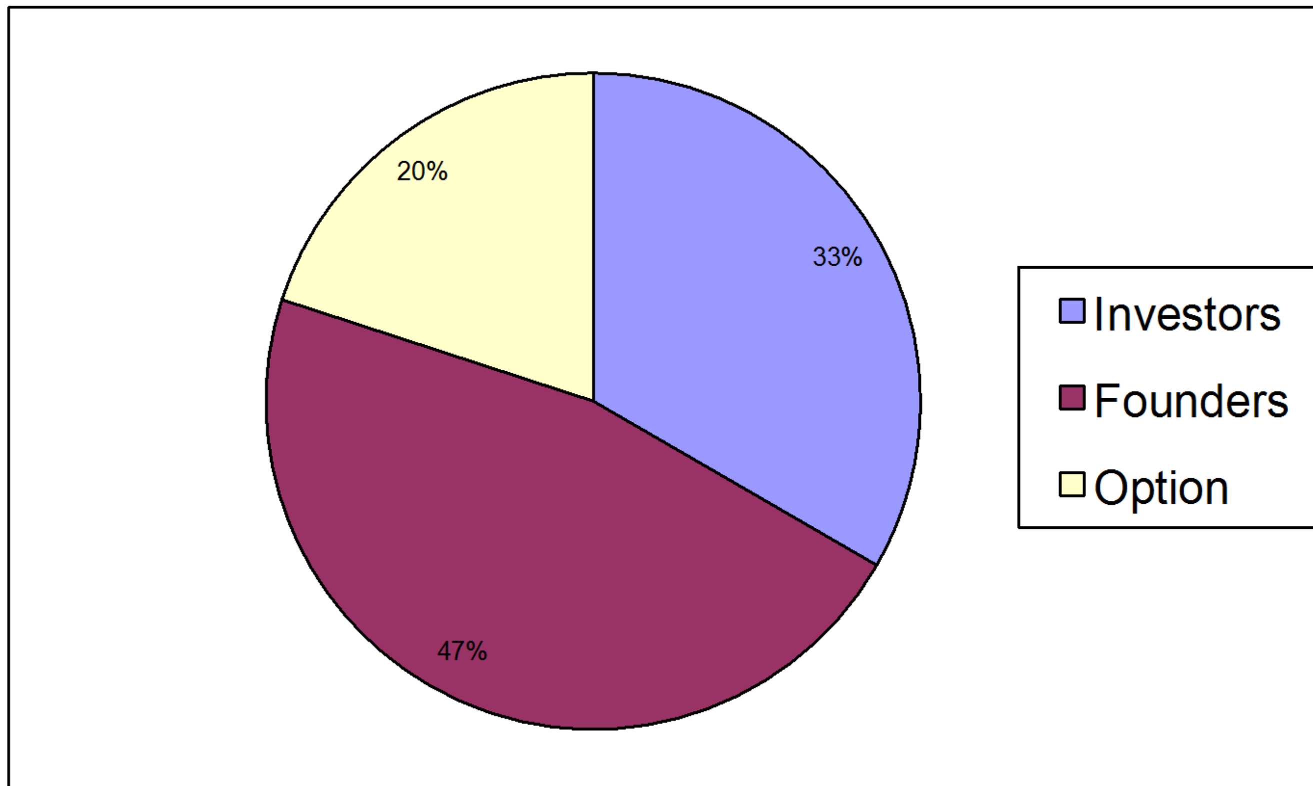
Option Pool

- Pre Money Valuation (With Option Pool)



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Easy Math Question

- Offer 1: Pre-Money Value of $10 million, $5 million investment, 10% Post-Money Option Pool
- Offer 2: Pre-Money Value of ***$11 million***, $5 million investment, ***20%*** Post-Money Option Pool
- Which is the "better" offer for the founders?

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Math Geek Part 1 Answer

- Offer 1, even though it's a lower "pre-money valuation." Effectively values the outstanding common stock higher because it includes a smaller post-money option pool. Here's the math:

- Offer 1 Values:

		O/S %	FD %
– Preferred Stock	$ 5,000,000	37%	33%
– Option Pool	1,500,000	NA	10%
– Common Stock	***8,500,000***	***63%***	***57%***
– Total Post-money	$15,000,000		

- Offer 2 Values:

– Preferred Stock	$ 5,000,000	39%	31%
– Option Pool	3,200,000	NA	20%
– Common Stock	***7,800,000***	***61%***	***49%***
– Total Post-money	$16,000,000		

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Term Sheet Language

- Pre Money Valuation and Option Pool

"Pre Money Valuation: The Per Share Purchase Price will be $2.00, which is based upon a fully-diluted pre-money valuation of $10,000,000 million and a fully diluted post-money valuation of $15,000,000 million (including an employee pool representing 20% of the fully diluted post-money capitalization)."

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Related terminology

- “Up round” – where subsequent round is at a pre-money valuation that is higher than post-money valuation of the prior round
- “Flat round” and “down round”
- “Value” is sometimes the tail wagging the dog – in early stage companies, investors are often looking for a certain percentage of the company, and will back into a “valuation” that fits their math
- “Cap table” skills highly rewarded

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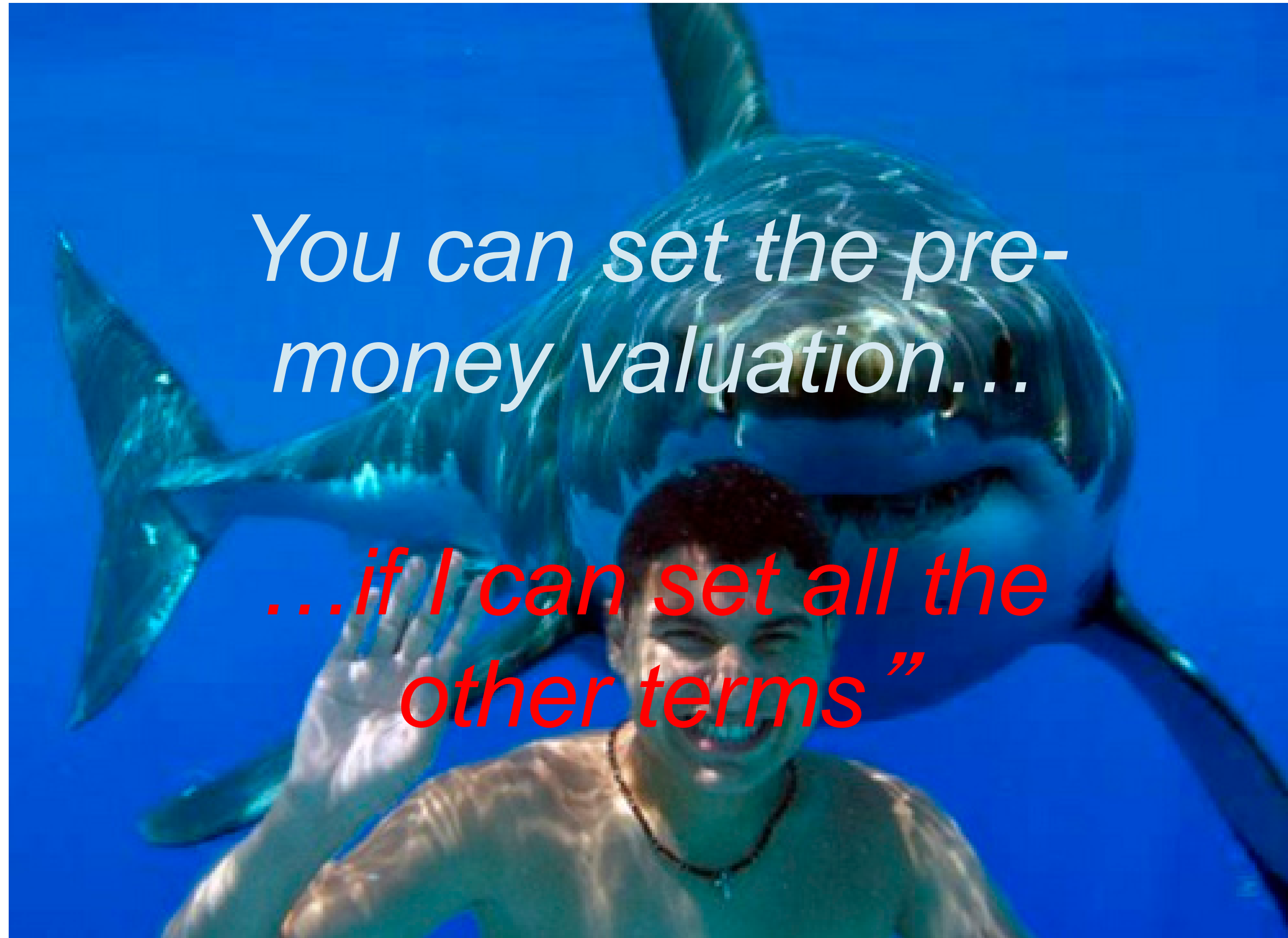
We got a high valuation!



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Liquidation Preference

- Applies when a “liquidation event” occurs (usually M&A)
- When distributing liquidation proceeds, preferred stock has right to get a certain amount of money back before the common stock gets anything (the “preference.”)

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Liquidation Preference

- Sometimes "multiples" are used (1x, 2x, 3x the investment amount)
- Sometimes accruing dividends are included (essentially like adding an interest rate component to the preference– range of 4% to 9% in Q3).
- "Preference overhang" refers to the total amount of liquidation proceeds that go to the holders of preferred stock before the holders of the common stock begin to share in the liquidation proceeds.

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Liquidation Preference

- Three main flavors (ranked in increasing order of bitterness):
  - – Non-Participating Preferred
  - – Capped Participating Preferred
  - – Uncapped Participating Preferred

Note: preferred always get the greater of either their preference or what they would receive if they converted to common stock

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What does the term sheet say?

"In the event of any liquidation, dissolution or winding up of the Company, the proceeds shall be paid as follows:

- ***Alternative 1 (Non-Participating Preferred Stock)*:** "First pay the Original Purchase Price on each share of Series A Preferred. Thereafter, the balance of any proceeds shall be distributed pro rata to holders of Common Stock."
- **Alternative 2 (Participating Preferred Stock with Cap):** "First pay the Original Purchase Price on each share of Series A Preferred. Thereafter, Series A Preferred participates with Common Stock on an as-converted basis until the holders of Series A Preferred receive an aggregate of [two] times the Original Purchase Price."
- **Alternative 3 (Participating Preferred Stock):** "First pay the Original Purchase Price on each share of Series A Preferred. Thereafter, the Series A Preferred participates with the Common Stock on an as-converted basis."

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Examples of Liquidation Preference

- Assume a $5m Series A investment at $20m pre-money valuation (resulting in the Series A investors owning 20% of the company). The company ends up being sold for $40m without any additional shares issued after the Series A investment.
- A "**1X Non-Participating Preferred**" means Series A get the greater of their $5m preference or what they would receive if they converted to common (i.e., 20% of $40m, or $8m).

  Result: $8m goes to the Series A (20%); $32m goes to the common stock (80%)

- A "**1X Participating Preferred with a 2X Cap**" means Series A get their $5m preference plus 20% of the remaining $35m up to a total 2X cap ($10m).

  Result: $10m goes to the Series A (25%); $30m goes to the common stock (75%)

- A "**1X Participating Preferred without a cap**" means Series A get their $5m preference (the "preferred") plus 20% of the remaining $35m, or $7m (the "participating").

  Result: $12m goes to the Series A (30%); $28m goes to the common stock (70%)

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Liquidation Preference – Take Aways

- Having a preference is standard, but focus on trying to minimize participation and accruing dividends.
- Understand how the preferences interplay so that everyone's incentives are aligned. It can get very complicated when multiple rounds are stacked up. In some cases you can have flat spots or even drastic jumps that create divergent incentives.
- The early rounds set a precedent for later rounds, so early investors that are too greedy on terms may live to regret it (use this argument to your advantage in negotiating favorable terms in the early rounds).
- Sometimes preference can be used to bridge a valuation gap, but again, worry about the precedent in that case.
- Generally not applicable in IPO

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Antidilution Protection

- Protects investors in a future "down round" - when new money is invested at a pre-$ valuation (or price per share) that is lower than the previous round's post-$ valuation
- Changes the conversion price used to calculate the number of shares of common stock issued when a share of preferred stock converts
- Two main flavors:
  - Full ratchet
  - Weighted average (broad-based and narrow based)
- Certain (critical) exceptions will not trigger the adjustment

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Control – Board Seats

- Usually preferred stock investors require one or more board seats
- Challenge: What is proper balance between founders, investors (both existing and new), and outside directors?
- Keep board size manageable – bigger is not always better
- Sometimes a "board observer" rather than board seat
- Think carefully about "CEO board seat" and consider "Founder board seats"

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Protective Provisions

- (aka "Negative covenants," "Veto rights" or "blocking rights")
- Essentially a list of things the company can't do without investors' consent

  - consent at either the Board or Stockholder level
- This is a foot on the break, not on the accelerator
- Usually hotly negotiated
- Gets complicated in later rounds; interests of investors can diverge
- The relevant thresholds are very important depending on the dynamics of your investor base

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Other Key Terms

- Co-sale ("tag along") rights
  - Ability to sell along side founders/management (and sometimes also other investors)
- Right of first refusal (ROFR)
  - Ability to purchase shares for sale by founders/management (and sometimes also other investors)
- Drag along rights
  - Ability to force all stockholders to go along with a sale that meets certain conditions. Focus on appropriate thresholds for founders/common stock.
- Founder vesting
  - Will often get renegotiated. Focus on what is vested up front and what happens on change of control.

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Other Key Terms (cont'd)

- Pre-emptive rights
  - Right to participate in future financings
  - Make sure it is based on fully diluted ownership, not % of preferred
- Pay to Play
  - Ability for investors to force each other to invest in future rounds.
- Information rights
  - Make sure appropriate restrictions on use and not sent to competitors
- Registration rights (IPO)
  - Standard and not worth heavily negotiating as long as reasonable

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Series B and later

- Series B and later will usually piggy back off of the Series A terms
  - Realize you will have to live with the Series A, generally terms can only get worse, not better
  - Further dilution and control issues
- Growth equity
  - Could be similar terms or could be opportunity to recap and cash out prior investors (and some portion of founder equity)
- IPO
  - The big homerun, but liquidity for the founders is still not necessarily immediate

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Final Thoughts

- Generate scarcity and interest:
  - best terms will come from competition
  - try to land multiple term sheets in a short window to increase your leverage and options
- Choose your investors wisely:
  - like a marriage with kids involved, you will be with them for a long time
  - think about how a given syndicate of investors positions you for the next round, including issues like signaling and available dry powder
  - all money is not created equal
  - do reference checks on your investors with others they have funded

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Final Thoughts (cont'd)

- Choose your fights wisely:
  - make sure you know what really matters to you, and understand the market dynamics.
  - don't be afraid to ask "why do you need that?"
- Choose your legal advisors wisely. This stuff gets complicated fast. Hire a lawyer with experience. And do it early (before negotiating the term sheet!)

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Questions?

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Other Resources

- Foley Hoag Venture Perspectives (our quarterly publication tracking terms of New England VC deals)
- NVCA Model Venture Capital Financing Documents (including model term sheet):
  - www.nvca.org (click “Resources” then “Model Legal Documents”) or use http://bit.ly/bj7Pn
  - Forms are intended as starting point only

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