Early Stage Capital: Term Sheets 101

15.391 Fall 2003
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Term Sheets 101

- Today's Goal:
  - ***Get everyone to a low common denominator re term sheet jargon and VC practice***
- Definitions
- Questions and Discussion

Team Sign Up

- Team formation
  - list of members
  - team name
- Scheduling on Sloan class server:
  - lawyer rounds
  - VC rounds
- **bid for 3 slots for each round**
- **<u>Deadline: 8:00 pm TONIGHT</u>**

Term Sheet Definitions
"Term Sheet"

- guts of the business deal
- NOT a "legal" document
- short (~5-8 pages)
- VC offers its template

Term Sheet Definitions "Preferred Stock"

- what VCs get
- "preferred" because it's got better rights and protections than common stock
- exact definition of preferences is key focus of negotiation (and this course)

Term Sheet Definitions
"Common Stock"

- what Founders and Employees get
- has voting rights but not much else
- options and restricted stock

Term Sheet Definitions “Valuation”

- “Pre-money”: value before financing
- “Post-money”: pre-money plus financing

Term Sheet Definitions “Valuation”

- VC stake stated as percentage of post-money:
  - *“4 on 6” =*
  - *$6M pre-money with $4M round =*
  - *$10M post-money; VCs own 40% of the company*

Valuation Jargon

- *"5 on 10" =*
- *$____ M pre with $ __ M round =*
- *$____ M post; VCs own ____%*

Valuation Jargon

- *"5 on 10" =*
- *$10 Million pre-money valuation with $5 Million of investment =*
- *$15 Million post-money valuation; VCs own 33% (5/15)*

Control, Ownership & Economic Power

- 5 Key Terms to Negotiate:
  - Board of Directors
  - Vesting
  - Option Pool
  - Participating Preferred Stock
  - Anti-Dilution Protection

Board of Directors

- Governing group of company
- Approves major strategic decisions
- Does not have operating role
- Shareholders elect, often by class vote

Board of Directors (continued)

- Not subject to public company regulations
- Pre-money--usually consists of employees only
- Post-money--a mix of VCs, employees, outsiders

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Board of Directors: *Term Sheet Issue*

- Composition post-money:
  - *Will investors have majority?*
  - *% VC ownership highly indicative*
  - *4-6 members post A Round*
  - *Aim for “2-2-1”?*

Vesting

- You don’t really own the shares you thought you did
- Legal mechanism: if you quit/get fired, the Company can buy back, *at your cost basis (pennies),* some percentage of your stock
- Typically, stock vests with the passage of time, but big events may accelerate vesting schedule

Vesting (continued)

- Vesting is artificially imposed by a separate contract, and typically is heavily negotiated in first rounds
- "Vested" stock is yours to keep, forever; Company's buyback right is only for "unvested" stock

Vesting:
Term Sheet Issues

- *Term*: ~3-4 years; varies by sector and region
- *Schedule:* "cliff"; quarterly; monthly
- "*Upfront":* getting credit for work previously done
- *"Acceleration":* extra credit when big things happen: change of control or getting booted if you "don't work out"

Option Pool

- Percentage of company's total stock post-money that will be reserved for future hires
- VC's preferred stock is added into calculation on "as-converted" basis (1:1) initially

Option Pool

- Irrelevant whether options have already been issued
- Typical A round: 15-25%
- Pool always comes out of founders', not VC's share
- How complete is your team?

Option Pool

- Typical "Cap Table" post-money:

Series A Preferred:	
VC 1	35%
VC 2	15%
total:	**50%**
Common:	
Founders	*30%*
Option Pool	20%
total:	**50%**

Option Pool

- Typical "Cap Table" post-money:

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Option Pool:
Term Sheet Issues

- Have you already lost effective control? ("The unborn vote only in Chicago")

- Can you wait for a "recharge"--when dilution affects VCs as well-- and argue for smaller pool now?

- Pool is necessity; don't cheap out. What's the right percentage for your stage?

Participating Preferred

- Description of certain rights that VC's stock gets upon "liquidation"

- 1. "Liquidation preference": VCs get 100% of original money back before Common gets one penny

- 2. Then, VCs "participate in" (take) pro rata share of leftovers with Common

Participating Preferred

- "Multiple liquidation preference": almost gone?
- Various aspects imprecisely referred to as "double dipping"
- Irrelevant in grand slam; matters only in middling outcome (thus, very important in 2003)

Participating Preferred

- VCs never give up their right to participate in upside
- VCs will always have alternative forms of payout, guaranteeing them (at least) the better of:
    - a straight liquidation preference or
    - pro rata share on as-converted basis

Participating Preferred Example

- Co. raises $40 on $60.
- VC takes standard participating preferred.
- Co. is acquired for $160 two years later.

Participating Preferred

- Co. has $60 pre-money valuation
- VC puts in $40
- Co. has $100 post-money
- VC owns 40% (4/10)
- 2 years later, Co. sold for $160...

Participating Preferred

- **$160 proceeds**
- **VC gets:**
  - $40 back right off the top (investment returned), **plus**
  - $48 = 40% of $120 (VC's percentage ownership of leftover assets)
  - $88 total **(55% of Co. value)**

Participating Preferred

- **$160 proceeds**
- **Common gets:**
- **$72** = $160 - $40 - $48
  - $40 = “VC’s preference”
  - $48 = “VC’s participation”

- **$72** total
  - **45% of Co. value, *despite***
  - **60% of Co. ownership**

MLP

- **Assume same facts, with VC 3X MLP**

- **$160 proceeds**
- **VC gets:**

  - $120 (VC's preference: 3X original investment of $40)
  - $16 (VC's participation: 40% of leftover $40)

  - **$136** = total return

MLP

- Assume same facts, with VC 3X MLP
- $160 proceeds
- Common gets: $24
  - ($160 - $120 - $16) =
  - 15% of Co. value, *despite*
  - 60% of Co. ownership

Participating Preferred *Term Sheet Issues:*

- Can you “push back on” the participating and get it out altogether?
- Can you get out the MLP?
- Can you get a cap on the participation feature?

Anti-Dilution Protection

- VC's protection in event of "down round" so that A Round investors' "conversion ratio" is equal to subsequent investors'.

Anti-Dilution Protection

- 2 flavors: “full ratchet” and “weighted average.”
- *Full Ratchet*: draconian; “if only one new share is issued” in B round, all A round investors entitled to B round’s conversion ratio.

Anti-Dilution Protection

- *Weighted Average:* Less harsh; takes into account the true dilutive effect of the subsequent down round.
  - broad-based (founder friendly)
  - narrow-based (almost like full ratchet)

Anti-Dilution Protection
Term Sheet Issues:

- Can you get VC to agree to broad-based, weighted average anti-dilution?