Early Stage Capital: Term Sheets 101

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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

- Deadline: 8:00 pm TONIGHT
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
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?
Typical “Cap Table” post-money:

<table>
<thead>
<tr>
<th>Series A Preferred:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>VC 1</td>
<td>35%</td>
</tr>
<tr>
<td>VC 2</td>
<td>15%</td>
</tr>
<tr>
<td>total:</td>
<td>50%</td>
</tr>
</tbody>
</table>

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<th>Common:</th>
<th></th>
</tr>
</thead>
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<td>30%</td>
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Option Pool

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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?