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QuickLaunch University Webinar Series

Term Sheet Basics and Negotiation Tips

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Webinar Guidelines

- Participants are in listen-only mode
- Submit questions via the Q&A box on the bottom right panel
- Questions will be answered as time permits
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Investment Instruments

Type	Description	Pro	Cons
SAFE (Simple Agreement for Future Equity)	Agreement to buy equity in future equity financing	• Simple • Pro-Founder • Solves Liquidation Preference Overhang • Postpones valuation discussion • Relatively inexpensive	• Investor - None of the protections of debt • Subject to the vagaries of future equity round
Convertible Note	Loan that is convertible in a future equity financing	• Potentially receives the protection of debt prior to conversion • Postpones valuation discussion • Relatively inexpensive	• Subject to the vagaries of future equity round • Potential tax exposure for discount • Potential Liquidation Preference Overhang
Stock	Common Stock Preferred Stock	• Sets Valuation • Sets Definitive Rights • Current Voting Rights	• Selling common stock can impact the pricing of equity incentives • Expensive • Complicated

The Term Sheet

- Summarizes principle terms of transaction
- Not legally binding, with key exceptions (confidentiality, exclusivity)
- Focuses parties on key issues → “morally binding”
- Generally prepared by Investor
- NVCA Form (equity investments)
  - Often contemplates use of NVCA transaction documents (standardized set of documents customized for the deal)
  - Many investors view the “customary” provisions of the forms to be non-negotiable

Principal Concerns in VC Transactions

Concern	Mechanism
Influence on Company	Composition of Board of Directors Veto Rights over certain Corporate Actions, Negative and Affirmative Covenants
Control over exit events.	Drag-along Rights, Tag-along Rights, Rights of First Refusal, Registration Rights
Ownership/Dilution.	Valuation/Capitalization Antidilution Protection (economic and structural) Pre-emptive Rights (equity)
Incentives for Management and Employees.	Options, Repurchase Rights

Capitalization and Valuation: Terminology

- Pre-Money Valuation: Value of the company prior to investment by the VC.

- Post-Money Valuation: Value of the company after the investment by the VC, i.e., the sum of the pre-money valuation plus the investment.

- Fully Diluted Shares: Generally defined as total issued and outstanding securities reported on an as converted to common stock basis. This number usually includes all issued and outstanding preferred stock, issued warrants, and options (often including unissued pool). *Be careful: this is the most commonly misused term in VC transactions.*

Capitalization and Valuation: Calculations

- To determine the price at which new shares of preferred stock should be issued, the effective price per share of existing common stock is determined based on the pre-money valuation

- The calculation:
  1. Negotiate the ***pre-money valuation*** based on industry comparables, market and target ownership percentage and investment amount.
  2. Calculate the number of ***fully diluted shares*** - the number of pre-money fully diluted shares, plus, any additional shares issuable due to antidilution protections (if any), plus, if the term sheet requires, any additional option pool shares.
  3. Divide the ***pre-money valuation*** by the number of ***fully diluted shares*** to determine a per share price.

Dividends

A specified rate of return on the investment

- may be cumulative or non-cumulative
- charter will specify when and how dividends can be declared (usually prohibits dividend on common stock unless comparable dividend is paid on preferred stock)
- preferred dividend usually expressed as a fixed $ amount or a percentage of per share purchase price
- cumulative dividends accrue whether or not declared, and become payable on some future date, if at all
- non-cumulative dividends may accrue if declared by the board but not paid when declared
- unpaid accrued dividends are payable upon closing of a sale event or IPO, upon conversion of preferred into common stock or upon redemption of preferred

Liquidation Preference

Provides a specific return (often the amount invested plus accrued and unpaid dividends) to holders of preferred stock in preference to other equity holders

- Traditionally thought of as downside protection but, can significantly affect upside (see participating preferred)
- Events triggering Liquidation Preference are critical, including
  - Dissolution or winding up of the company
  - Merger or sale of the company
  - Other transaction involving a change of control (i.e. exclusive license)

Liquidation: Participating Preferred

- Investor recovers per share investment amount (and perhaps accrued dividends) and then participates in remaining distributions to holders of common stock as if preferred stock was converted into common stock.
- Potentially disastrous impact on founders' stock if acquisition does not yield a decent internal rate of return (IRR)
- *Limit:* Company should resist, or at least limit with "IRR Hurdle" / multiple of invested capital threshold such that investor forfeits this right when some return threshold is met

Preferred Stock Covenants

- Affirmative: Company must deliver financial and other information, provide access to management and corporate records, maintain agreed upon board representation and frequency of meetings
- Negative: Company may not take specified corporate actions without investor approval (see class voting rights)
- Remedies for violating covenants can problematic and may result in loss of control (or loss of trust in) founders, change in board composition or other, more problematic results (i.e. unwinding of a corporate action)
- *Limit*: Company should attempt to minimize covenants and set thresholds high enough to allow management flexibility to run the company

Class Voting Rights

- Investor has ability to block important corporate transactions
  - Mergers, sales of stock or assets
  - Issuances of additional preferred stock
  - Option grants and option vesting schedules
  - Incurrence of debt
  - Sales or transfers of technology

- *Limit:* Company should seek end to class voting rights if preferred holds less than certain equity % of company, and to minimize the list of actions that trigger a class vote

Stockholder's Agreements

Provides certain control of transfers of company securities and participation in such transfers.

Three types of protection:

- ***Right of First Refusal*****:** Right to purchase any securities proposed to be sold by certain stockholders (usually founders, sometimes other stockholders) on the proposed terms
- ***Tag-along / Co-sale Right:*** Right to participate in proposed sale by certain stockholders
- ***Drag-along Right:*** Right for certain stockholders to take other security holders along in an exit transaction (typically majority of board and a certain group of stockholders)

Antidilution Protection

- Preferred Stock converts into common stock at a certain conversion ratio, likely to initially be 1:1.

- Three types of antidilution protection:

  - ***Structural:*** If a change is made to the common stock (stock split, combination, dividend) the conversion ratio must be adjusted to allow the preferred to convert into a proportionate number of shares of common stock (this is never controversial)

  - ***Economic/Price:*** If a later round is sold at a lower price per share, then the investor's shares are effectively repriced by adjusting the conversion ratio

  - ***Equity:*** Investor’s percentage ownership is protected

Economic/Price Antidilution Protection

- If subsequent rounds of financing are dilutive as to price, investor gets to reprice the old money using today's dilutive valuation based on one of the following formulas:
    - ***Full Ratchet Formula***: If company issues even one share at lower price, conversion rate of preferred is reduced to equal lower price (unusual)
    - ***Weighted-Average Formula***: Factors in overall impact of total shares issued in new dilutive round and adjusts old conversion rate based on impact on total capitalization (can be either narrow or broad based depending on number of shares to be used in calculation)

Equity Antidilution: Preemptive Rights, ROFRs, and ROFOs

- ***Preemptive Rights:*** Investor can purchase some portion of new issuances – often set to maintain % equity interest in company
- ***Right of First Refusal:*** Investment syndicate can purchase some or all of any shares issued in future financings (if right is to all new shares, it can prevent company from attracting fresh money) – Note: Different than Right of First Refusal for sales by stockholders
- ***Right of First Offer:*** Company goes to current investors first with proposed valuation; if investors don't buy can go to outside investors

Board Composition

- Class voting set forth in Certificate of Incorporation; right of certain investors to elect certain members is usually set forth in separate Voting Agreement
- Investor representation often tracks the money
- Management needs board representation
- Importance of independent directors

Redemption

- Guarantees that investor can get money back after some period of time
- Depends on stage of company and venture fund investing, business plan and profitability model (typically 5-7 years)
- Redemption for dollars invested, dollars plus accrued dividends, stated return, or fair market or appraised value
- Corporate law prevents company from redeeming equity without “surplus”
- Redemption trends are often industry-specific
- Delinquent redemption: interest, increase in conversion rate and/or dividend rate for missed redemption and possibly change of board control

Registration Rights

- Investor obtains liquidity by participating in a public offering or demanding liquidity by forcing company to go public
  - Demand Rights: Investor can compel company to register shares of public or to go public even if management does not want to
  - Piggy Back Rights: Investor can include common shares if company does IPO or other registered offering
  - Form S-3 Short-Form Rights: Secondary offerings for investor-only liquidity, company must have completed its IPO

Incentives-Basket For Management Shares

- Get agreement from investors: Certain % of capitalization set aside as option pool for future employees or to reward existing talent
  - Carved out of Economic/Price Antidilution
  - Option pool dilution shared on a pro rata basis by investors & founders
  - Pool or basket typically represents 10%-25% of total fully-diluted capitalization, post financing

Incentives-Vesting/Repurchase of Founder Shares

- Investors may require founders or managers to subject their original shares to vesting and require shares to be sold back to the Company at original cost or some other formula based on termination of relationship with the Company

- Issue:
  - How much vested at time of investment?
  - What happens to shares if terminated w/o cause or voluntarily or because of death/disability?
  - Vesting period: annual/quarterly/monthly?
  - Buy-out price?

Other Notable Deal Terms and Trends

Pay-to-Play

- Holders of preferred stock must participate in the future rounds of financings or risk:
  - Loss of specified rights
  - Conversion to shadow/junior class of preferred or common stock
- Implemented to keep investor syndicate motivated to continue to fund the company
- Rare at early stages, remains uncommon in later stages
- May be implemented in tranched financings (slightly different rationale)

Other Notable Deal Terms and Trends

Down-Rounds

- Financing the values the company below the post-money valuation from the previous round (lower price per share)
- Issuing shares below the per share price(s) of previous series triggers antidilution protection—potentially dramatic impact on common stockholders
- Things to consider:
  - Effect on employee confidence/morale
  - Impact to company's future fundraising efforts
  - Alternative funding strategies:
    - flat round
    - bridge note financing

Other Possible Deal Terms and Trends

Tranched Financings

- The investment from the initial investor(s) is divided into multiple closings, with future closings usually dependent on achievement of milestones
- Why? Valuation uncertainty or concerns for the investors; investors attempt to create additional incentives for the company to perform well; to provide investment flexibility for investors; and/or due to the leverage of investors
- Consider:
  - Same series of shares/purchase price?
  - What are the milestones? Are they achievable?
  - Who determines when/if the milestones are achieved?
  - Certainty of achievements/penalty for non-participation?

Convertible Note Term Sheets: Key Terms

- Interest Rate – typically 5-8%
- Maturity Date – typically 12-24 months
- Conversion Discount/Cap
- Effect of Sale of the Company
- Events of Default
- May be Secured or Unsecured

SAFE

- Developed by Y Combinator
- Not Debt
  - No maturity
  - No interest
  - State lending regulations are not applicable
  - No debt protections
- Simple
  - Can accommodate: discounts, caps, most favored nations
- Consider
  - Majority amendment provision
  - Participation rights

Questions

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