Early Stage Capital: Term Sheets 101

15.391 Fall 2010
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Team Sign Up

- Team formation
  - list of members
  - team name
  - Team contact
- Send schedule availability by email to James:
  - lawyer rounds
  - VC rounds
- **Deadline: email by 8:00 pm Monday, November 1**

Overview
Mechanics and Industry Trends

Overview:
VC Investment Process

- Step 1: Pitching to Investors: investor high-level due diligence: 2 weeks-2 yrs
- Step 2: Decision by investor to invest: 2 weeks-4 months
- Step 3: Term sheet negotiation: 2-4 weeks

Overview: VC Investment Process

- Step 4: Financing Documentation:
  Lawyer Time: 4-12 weeks
  - Legal and continuing business “due diligence”
  - Draft big thick legal docs: Purchase Agreement; Articles of Incorporation; Voting Agreements, etc.
  - Prepare closing deliverables: legal certificates, government filings, etc.
- Step 5: Sign and close: **MONEY**
- Step 6: Additional closings: milestones, tranches, etc.

Venture Investment Trends

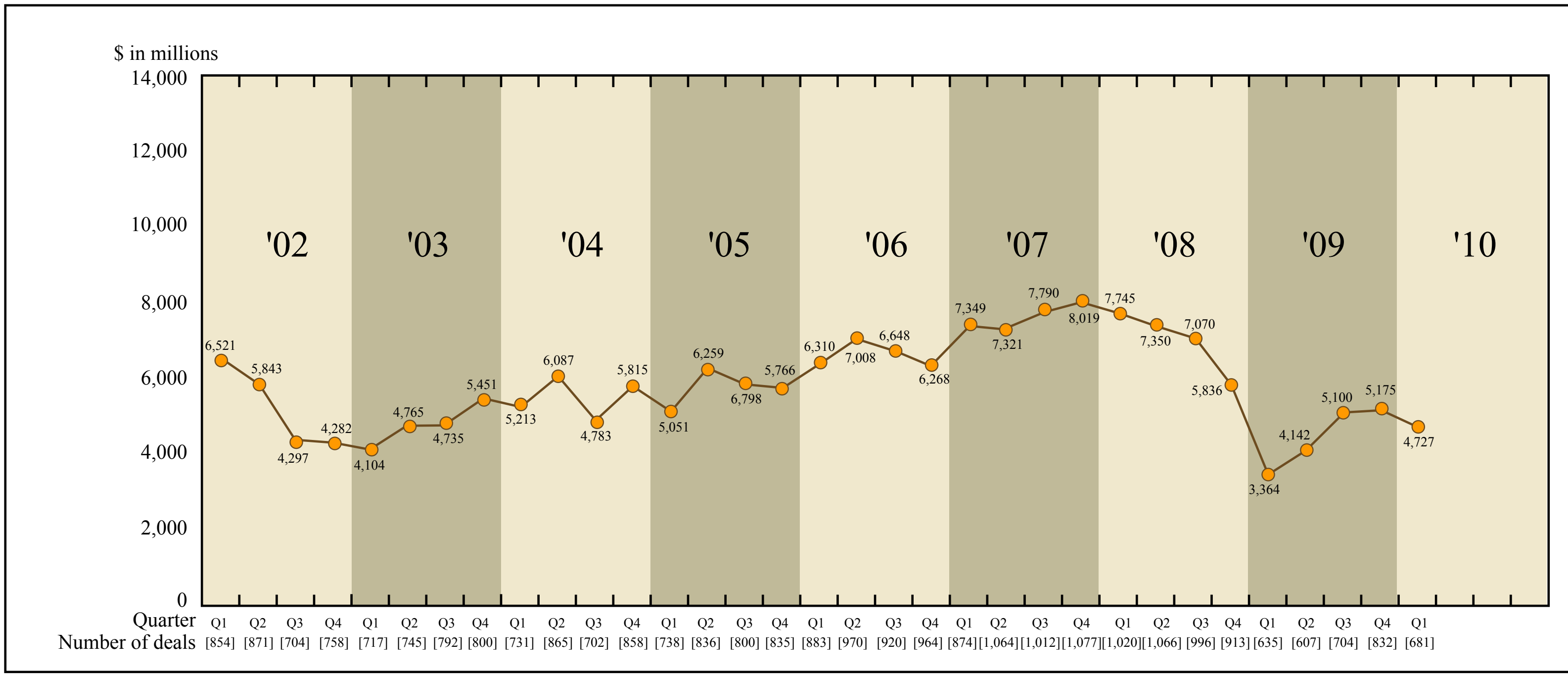

Image by MIT OpenCourseWare.

Source: PWCMoneytree.com 2010

Early vs. Later Rounds

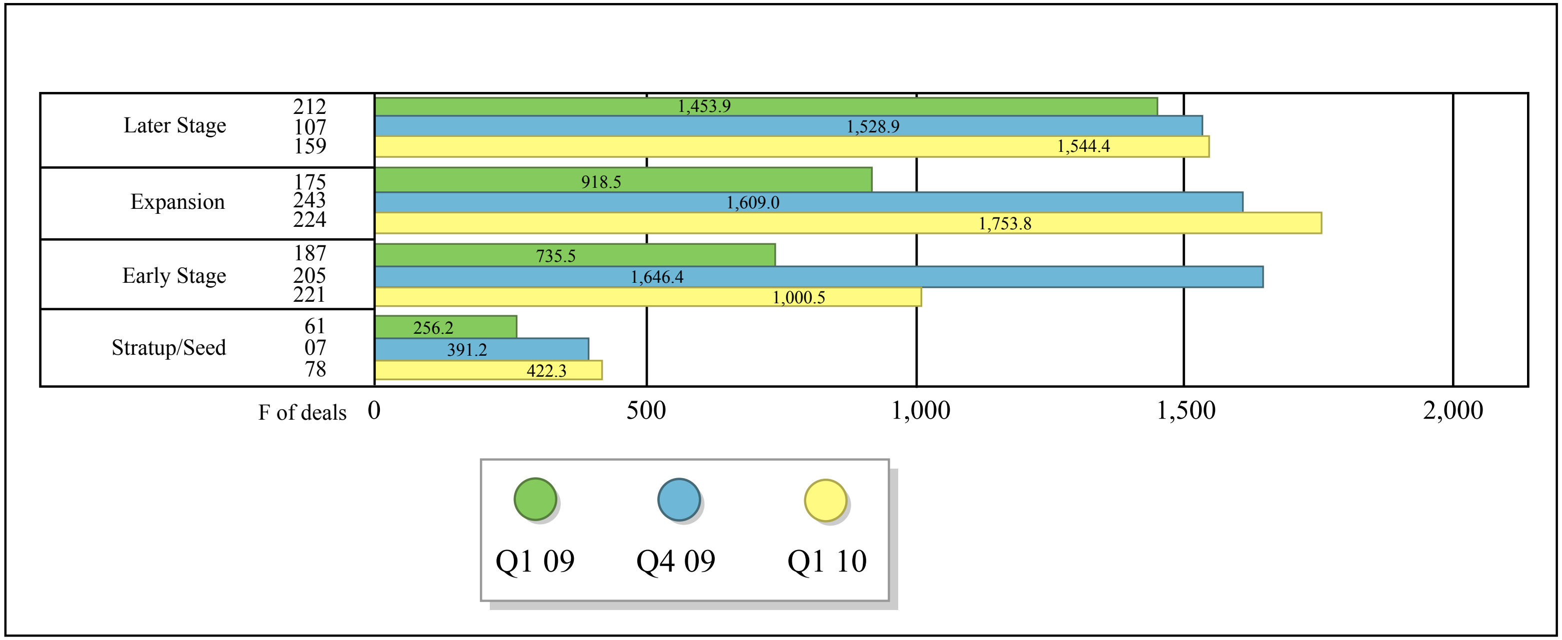

Image by MIT OpenCourseWare.

Source: PWCmoneytree.com 2010

Term Sheets 101

- Today's Goal:
  - Get everyone to a low common denominator re term sheet jargon and VC practice
- No jargon without explanation
- Questions and Discussion

Term Sheet Basics

"No questions are dumb today"

Term Sheet/VC Resources

- Endless, rich resources online
- Hundreds of blogs
- NVCA model documents
- PWCMoneytree & law firm statistics
- TIE, TCN events
- VC Conference, 100K, VCPE Club,

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 "Common Stock"

- what Founders and Employees get
- has voting rights but not much else
- very cheap, especially at A round
- options and restricted stock

Term Sheet Definitions “Preferred Stock”

- what VCs get
- “preferred” because it’s got better rights and protections than common stock
- also costs more than common
- exact definition of preferences is key focus of negotiation (and this course)

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

- ***You be the VC:***
- *"5 on 10" =*
- *$____ M pre with $ __ M round =*
- *$____ M post; VCs own ____%*

Valuation Jargon

- ***You be the VC:***
- *"5 on 10" =*
- *$ 10M pre-money looking for $ 5 M round =*
- *$15 M post; VCs own 33 %*

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
  - Preferred Stock Perks: Participation
  - Preferred Stock Perks: Anti-Dilution

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

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

Board of Directors: *Term Sheet Issues*

- Composition post-money:
  - *Will investors have majority?*
  - *% VC ownership highly indicative*
  - *4-6 members post A Round*
  - *Aim for "2-2-1"?*
    - *Who is the "1"?*
    - *How chosen?*

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 (probably 0),* some percentage of your stock
- Typically, stock vests with the passage of time, but big events may accelerate vesting schedule

Vesting

- 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
- Note: Founders are often issued "restricted" stock, which has an analogous feature like vesting

Vesting:
Term Sheet Issues

- *Term*: ~3-4 years; varies by sector and region
- *Schedule:* “cliff”; quarterly; monthly
- “*Upfront”:* getting credit for work previously done—important for founders
- *“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 is reserved to grant to future hires

Option Pool

- Typical A round: 15-25%
- Pool always comes out of founders', not VC's, share
- How complete is your team? Do you have a hiring plan?

Rough Ranges of Option Grants

- (i) CEO – 5% to 10%; 5.40% avg.
- (ii) COO – 2% to 4%; 2.58% avg.
- (iii) CTO – 2% to 4%; 1.19% avg.
- (iv) CFO – 1% to 2%; 1.01% avg.
- (v) VP Engineering – .5% to 1.5%; 1.32% avg.
- (vi) Director – .4% to 1%

Source: CompStat

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*

- Use the hiring plan to minimize
- Argue for smaller pool now and wait for a "recharge"--when dilution affects VCs as well
- Pool is necessity; don't cheap out. What's the right percentage for your stage?

Preferred Stock Perks: Participation

- Certain rights that VC's stock gets upon "liquidation" (M&A; sale of assets)
  - 1. "Liquidation preference": VCs get 100% of original money back before Common gets one penny
  - 2. "Participating preferred" permits VCs to share the leftovers "pro rata" with Common
- Irrelevant in grand slam; matters only in middling or lousy outcome

Participating Preferred Example

- Co. raises $50 on $50.
- VC takes standard participating preferred.
- Co. is acquired for $200 two years later.

Participating Preferred

- Co. has $50 pre-money valuation
- VC puts in $50
- Co. has $100 post-money valuation
- VC owns 50% (5/10)
- 2 years later, Co. sold for $200...

Participating Preferred

- **Starting with $200 proceeds:**
- **VC gets--**
  - $50 back right off the top (liquidation preference),

plus

  - $75 = 50% of $150 (VC's percentage ownership of leftover assets: participation perk)
  - **$125 total (62.5% of Co. value, *although* only 50% Co. ownership)**

Participating Preferred

- **<u>Starting with $200 proceeds:</u>**
- **Common is left with--**

  - $200
    50 (“VC’s preference”)
    <u>- 75</u> (“VC’s participation”)

  - **<u>$75</u>** total **(37.5% of Co. value, *despite* 50% of Co. ownership. . . and having done all the work to create the value . . .)**

Participating Preferred

In sum, the power of Participating Preferred cushions VCs with "juiced" returns:

VCs get:

<u>$125</u> total

62.5% of Co. value, *although* only 50% Co. ownership

Common gets:

<u>$75</u> total

37.5% of Co. value, *despite* 50% Co. ownership

Preferred Stock Perks: Participation

- "Participating Preferred" variants:
  - None: Investors get no "double dip;" only their liquidation preference: "straight preferred"
  - Multiple Liquidation Participating Preferred: Rare but very nasty; usually later rounds
  - Full Participation: Investors share PRO RATA with Common, without limit
  - Capped Participation: Investors share Pro Rata with Common but only UNTIL ~2-5X return received

Preferred Stock Perks: Multiple Liquidation Participation

- Uncommon, brutally unfair
- Devastating in middling and poor outcomes
- VCs take a ***multiple*** of their liquidation preference out before Common has a chance to see a penny
- In 5 on 5 example, with 3X MLP and $20M exit:
  - VCs get $15 back(3 x 5), off the top
  - Then share 50% of remaining 5M –
  - That is, $17.5M to them
  - $2.5 M to Common
  - Even though each class owns 50%

Preferred Stock Perks: Convertibility

- Preferred stock will always be convertible, at the investor's option, into common stock
- Initial conversion ratio is 1:1; will change over time
- Standard

Capped Participating Preferred

Assume $5M preferred investment for 50% of Company

Sale of Company @	No Cap	3X Cap	Convert to Common	VC's Choice if capped
$12M	$8.5M (5 + 3.5)	$8.5M* (5 + 3.5)	$6M	Preferred
$40M	$22.5M (5 + 17.5)	$20M (5 + 15)	$20M	Indifferent
$41M	$23M (5 + 18)	$20M (5 + 15)	$20.5M	Convert
$225M	$115M (5 + 110)	$20M (5 + 15)	$112.5M	Convert
$1005M	$505M (5 + 500)	$20M (5 + 15)	$502.5M	Convert

Participating Preferred

- VCs never give up their right to participate in upside
- Currently, used in about ~50% of deals
- Through the conversion feature, 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 *Term Sheet Issues:*

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

Other Terms that Matter

- Protective provisions
- Founder reps
- Tranched investment
- No-shop provisions

  - *You will take these up in Tuesday's class and in your lawyer rounds*

Term Sheet Subtext

- It's all about the relationships:
  - Between VC and founders
  - Between VC and its LPs
  - Between VCs within syndicate
- Trust and comfort level are surprisingly big drivers

Just the beginning . . .

- Conversion Rights
- Redemption Rights
- Pay to Play provisions
- Redemption Rights
- Dividends
- Rights of First Refusal
- Information Rights
- Piggyback Registration Rights
- Drag-Along Rights
- Tag-Along Rights

. . . This is what lawyers are for--

Preferred Stock Perks: 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. iow, A round is effectively repriced to B round's (lower) price. Rare today.

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)

Weighted Average is standard today

Anti-Dilution Protection
Term Sheet Issues:

- Can you get VC to agree to broad-based, weighted average anti-dilution?
- Can you get VC to take out full ratchet after B round? After hitting targets?