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Term Sheets and Valuation

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What is a term sheet?

- aka- “Letter of Intent,” “Memorandum of Understanding,” “Agreement in Principle”
- Basic agreement on the material terms of the transaction
  - Road map, marching orders
- More detail is generally better (especially for the company/seller)
- Legally binding? For the most part, no, but…..
- If you really want to mess up your transaction, this is the place to do it

Non Binding

- A term sheet is not a binding agreement to fund
  - Subject to actual documents
  - Subject to due diligence
  - Subject to other closing conditions (legal opinion etc.)
  - ***Timeline from Term Sheet to closing has been much longer and much more uncertain in the last two years***
- Confidentiality
  - Term sheets typically have a binding confidentiality provision prohibiting disclosure of the terms and the existence of the term sheet
- Exclusivity
  - Term sheets typically give the investor some period of exclusivity (45 to 90 days)

Founders' Main Concerns

- Loss of control over your company
- Dilution of your personal equity position in your company
- Subject to having your stock repurchased if terminated
- Is the financing adequate for your plans
- Future capital needs and dilution
- If debt, is there a security interest in key assets of the company
- Success of partnership with angels and VCs – access to key industry contacts, future $, business guidance

Investors' Main Concerns

- Accuracy of valuation (both present and projected)
- Risk level of investment
- Projected return on investment (ROI)
- Liquidity if business in distress (downside protection)
- Ability to participate in later rounds
- Influence and control over management and strategic direction

Convertible Preferred Stock

- Why Convertible Preferred Stock?
  - "Preferred" - Preference over common stock on dividends, distributions, liquidation, redemption
  - "Convertible" - All of the upside of common stock

Pre-Money Valuation

- "Pre-Money Valuation" is the value given to the company before the transaction. It allows for the calculation of the share price, which is equal to the pre-money valuation divided by the number of shares "outstanding" before the transaction:

  *Share Price = Pre-money Valuation / **Pre-money Shares Outstanding***

- Critical Issue –What shares are being counted in the "Shares Outstanding" number? (All outstanding options? Options reserved under the option pool? What is the size of the option pool?). The higher the number of shares deemed "outstanding," the higher the number of shares (and "actual" percentage of the company) that the investors receive for the same dollar amount of investment.

Post-Money Valuation

- Post-money valuation is the sum of the pre-money valuation plus the amount invested.

Math Geek Part 1

- 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?

Math Geek Part 1 Answer

- Offer 1, even though it's a lower "pre-money valuation." It values the outstanding common stock higher because it includes a smaller post-money option pool. Here's the math:
- Offer 1 Values:
  - Preferred Stock $ 5,000,000
  - Option Pool 1,500,000
  - Common Stock ***8,500,000***
  - Total Post-money $15,000,000
- Offer 2 Values:
  - Preferred Stock $ 5,000,000
  - Option Pool 3,200,000
  - Common Stock ***6,800,000***
  - Total Post-money $16,000,000

CAUTION!

- Valuation is only one of many economic terms.
- As the saying goes, a VC will gladly let you pick the valuation if they get to pick all the other terms. You can construct the other economics in many ways, the easiest of which is the liquidation preference…

Liquidation Preference

- Liquidation preference = the right of the holders of preferred stock to get their money back (and perhaps more) before the common stock when a “liquidation event” occurs (generally, an M&A transaction). Sometimes “multiples” are used (1x, 2x, 3x). Sometimes accruing dividends are included.
- “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.
- Three main flavors:
  - No participation
  - Participating preferred (aka “Piggy Preferred”)
  - Capped participation

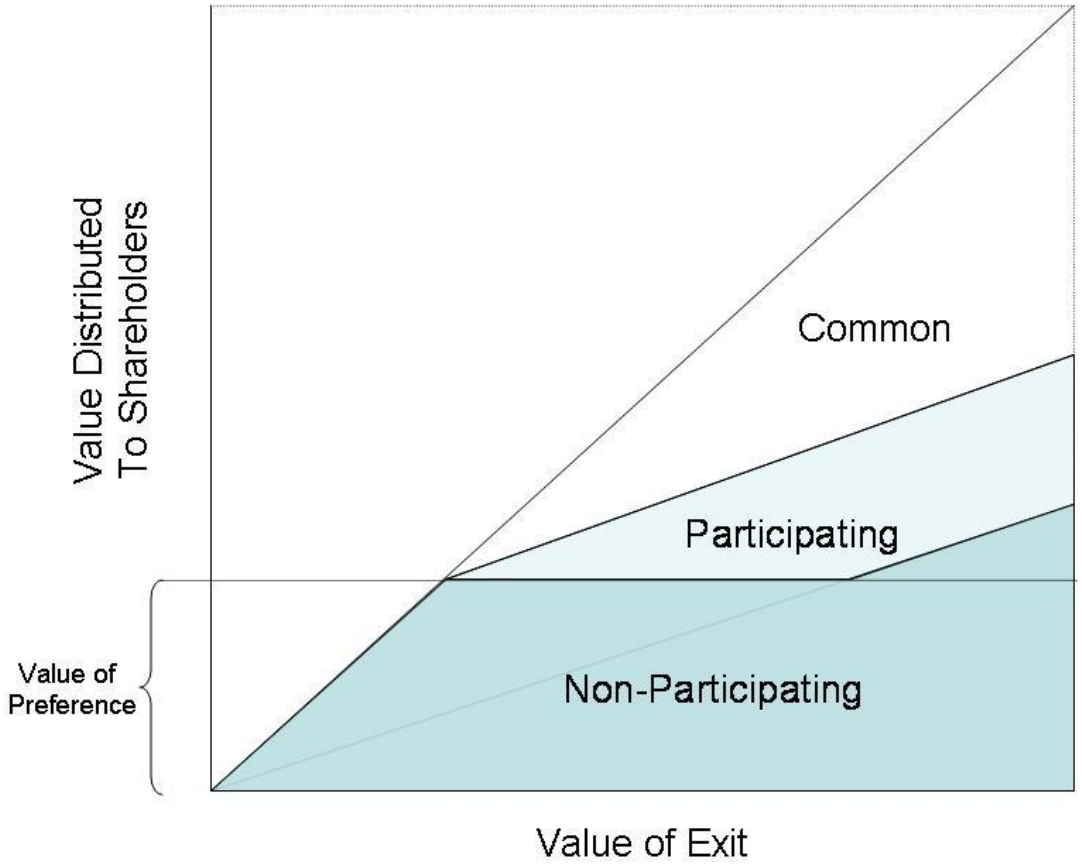
Math Geek Part 2

- Assume we took Offer 1 ($10 pre and $15 post) and a year later we sold the company for ***$30 million*** (with the option pool fully issued/vested for simplicity). Here are how different preferences and participation rights would play out:
- 1x preference, no participation:
  - Preferred Stock: $10 million (33% of proceeds)
  - Common Stock: $20 million
- 1x preference, full participation:
  - Preferred Stock: $13.3 million (44% of proceeds)
  - Common Stock: $17.7 million
- 1x preference, participation capped at 2x:
  - Preferred Stock: $10 million (33% of proceeds)
  - Common Stock: $20 million
- 1x preference, participation capped at 3x:
  - Preferred Stock: $13.3 million (44% of proceeds)
  - Common Stock: $17.7 million
- 3x preference, full participation:
  - Preferred Stock: $20 million (67% of proceeds)
  - Common Stock: $10 million

Math Geek Part 2

- Now assume it was only ***one week*** later and for ***$15 million***:
- 1x preference, no participation:
  - Preferred Stock: $5 million (33% of proceeds)
  - Common Stock: $10 million
- 1x preference, full participation:
  - Preferred Stock: $8.3 million (55% of proceeds)
  - Common Stock: $7.7 million
- 1x preference, participation capped at 2x:
  - Preferred Stock: $8.3 million (55% of proceeds)
  - Common Stock: $7.7 million
- 1x preference, participation capped at 3x:
  - Preferred Stock: $8.3 million (55% of proceeds)
  - Common Stock: $7.7 million
- 3x preference, full participation:
  - Preferred Stock: $15 million (100% of proceeds)
  - Common Stock: $0

Math Geek Part 2



Source: www.wikipedia.org

Antidilution Protection

- Addresses Investors' concern re: valuation
- Changes the conversion price used to calculate the number of shares of common stock issued when a share of preferred stock converts
- Helps protect investors in the case of a "down round," when new money comes in at a total pre-money valuation (or price per share) that is lower than the previous round's post-money valuation.
- Two main flavors:
  - Full ratchet
  - Weighted average (broad-based and narrow based)

Weighted Average

- Weighted average anti-dilution adjustment takes into account the proportional relevance (or weight) of each component in the calculation rather than treating each component similarly.
- In a down round, the conversion price of the Series A is lowered to a price that is an average of the price at which the company sold the new stock, valuing the common stock outstanding at the pre-adjusted conversion price.
- Sometimes formulated as “broad-based” and sometimes as “narrowly-based.” (“narrowly-based is more favorable to the protected preferred stock.)
- More common than full ratchet, and much less onerous to un-protected stockholders.
- Formula:

$$\text{New price} = \frac{(P1)(Q1) + (P2)(Q2)}{(Q1) + (Q2)}$$

Full Ratchet

- The conversion ratio of the protected preferred stock is "ratcheted down" to the lowest price at which securities are sold in the down-round (where stock is sold at a price lower than the earlier protected round). This applies even if only one share is sold. It treats all subsequent down-round stock issuances similarly, resulting in an adjustment to the conversion ratio regardless of the number of shares issued.
- Very onerous, and increasingly less common (although lately making a comeback).

Math Geek Part 3

- Assume again Offer 1 is closed on ($10m pre and $15m post). Subsequently, the company has to raise an additional $2.5 million in a Series B at a $7.5 million pre-money valuation (a 50% decline from the $15 million post-money).
- If the Series A had no antidilution, the resulting cap table would be:
  - Series B: 25% ($2.5 million)
  - Series A: 25% ($2.5 million)
  - Common: 50% ($5.0 million)
- If the Series A had “full ratchet” antidilution, the resulting cap table would be:
  - Series B: 25% ($2.5 million)
  - Series A: 50% ($5 million)
  - Common: 25% ($2.5 million)
- If the Series A had “weighted average” antidilution, the resulting cap table would be:
  - Series B: 25% ($2.5 million)
  - Series A: 27.5% ($2.75 million)
  - Common: 47.5% ($4.75 million)

Other Key Terms

- Board seats
- Co-sale rights
- Dividends
- Drag along rights
- Information rights
- Pre-emptive rights
- Protective provisions
- Registration rights
- Right of first refusal

Convertible Notes

- Conversion rate and company valuation (discount to future round)
- Automatic conversion on qualified financing
- Payment on acquisition
- Interest rate
- Maturity date
- Collateral (secured or not)
- Amendment of notes

Other Resources

- www.emergingenterprisecenter.com:
  - –Glossary (commonly used terms)
  - –Ask the Startup Lawyers (common questions and answers; submit your questions!)
  - –EEC 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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Questions?

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