

Venture Capital Term Sheet: An Exercise in Negotiation

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ABSTRACT

This paper attempts to build on the traditional term sheet lecture by providing an interactive term sheet exercise. Students will be placed into roles as either Venture Capitalists or Entrepreneurs and be given the task of negotiating a term sheet for a company. The goal of the paper is twofold. One is to enhance the learning of students through the creation of a term sheet. Students often have better connections with material once they see the application of the material. Second, this exercise gives students an exposure to term sheets to prepare them for future career in Venture Capital or as owner of their own company.

INTRODUCTION

Entrepreneurs seeking venture capital funding find themselves in the position of negotiating with one or sometimes more than one venture capital firm on numerous important issues. These issues often include but are not limited to the amount of capital to be raised, the investment terms, control of company, value, and final liquidation of the company. The formal coming together by the two sides to negotiate important terms is known as the “term sheet”. Most venture capital or alternative investment courses discuss the idea of term sheets with the typical approach a lecture on term sheets to explain to students the importance of term sheets for both the venture capitalist (henceforth VC) and the entrepreneur. Although this provides a nice background for students it does not provide the true experience of negotiating a term sheet, which is critical for both VCs and especially entrepreneurs, who typically have no experience with term sheets before negotiating for their company.

In this paper we take the traditional approach one step further by providing a realistic term sheet experience to students. We put the students in the role of both VC and entrepreneur. Venture capital firms, typically prepare the term sheet to include the terms under which they are willing to invest their capital. This is how we begin the negotiation exercise for students. We separate the class into two distinct groups. Half the class would be in groups of entrepreneurs and the other half would be groups of VCs. These groups are matched up and the VCs and entrepreneurs agree on the final terms, and a completed term sheet will be made between each set of groups. Groups will then discuss their final agreements with the class. After the final term sheets are presented in class, it will open a good opportunity to discuss the conflicts of interest that arise when hammering out the term sheet. Students will have firsthand knowledge of the difficulty in trying to iron out all of the fine details held in the term sheet and the negotiating necessary.

This exercise has two primary goals. One is to better educate students on term sheets through a learning exercise and two is to better prepare students for their potential future as it may be as an entrepreneur or as a VC. All too often entrepreneurs find themselves on the short-end of the

stick when trying to negotiate with a VC. VCs typically have all the power when dealing with entrepreneurs when it comes down to negotiating terms as they have vast experience while entrepreneurs have no experience working through a term sheet. This exercise will bring this mismatch to light by putting the students in both the role of VCs, who typically have all the power as well as the entrepreneur who typically lacks of power.

TERM SHEET EXERCISE DETAILS / TEACHING NOTES

First, students will be broken up into their respective groups, either groups of entrepreneurs or VCs. Each group of students would be given the handout that matches their group. Each group of entrepreneurs will be paired up with a group of VCs, so there has to be an even number of groups in the exercise. The VC groups are given the handout matching VCs which have goals these groups are attempting to achieve, while the entrepreneurs are given the handout matching their goals. The individual handouts for both entrepreneurs and VCs are shown in Appendix A of the paper. Students are also given a copy of a term sheet provided on the National Venture Association website. A copy of this term sheet is included in Appendix B of this paper. Students will also be provided with information on a real company for which to negotiate terms of a deal. This can also be done using a mock company as well. At this point there are two options for the exercise. One is that groups of students can be provided the same company or each pair of VCs and entrepreneurs could have different companies. In this exercise we focus on using the same company among all pairs of VCs and entrepreneurs as it allows the instructor to observe interesting differences in negotiating between different groups of students. Some groups of VCs may prove to be stronger than others in negotiating and the same could be said for the groups of entrepreneurs.

The task for students is to negotiate as many terms as possible throughout the term sheet provided. The groups of VCs are charged with attempting to quantify some terms they would like to offer to the entrepreneur. After the groups of VCs and entrepreneurs look through the term sheet with blanks on some of the key issues for twenty minutes or so and attempt to figure out terms. If students become stuck, a potential starting point would be a typical VC friendly (overwhelming favorable to VCs) term sheet actually used in the venture capital deal for the company provided will be given to groups. If the students are making good headway in negotiating terms than this jump start can be eliminated. Since venture capital firms are often more sophisticated and have more power than the companies seeking capital, and it becomes the entrepreneurs charge to attempt to mitigate this advantage by pointing out all of the important terms in the term sheet. The entrepreneurs' task is to figure out every term appearing to heavily favor the VC and come up with terms that would suit them better. After coming up with the different issues listed within the term sheet, the entrepreneur will respond with what changes they would like to make within the term sheet and why. Then these terms will be negotiated by between the different groups of VCs and entrepreneurs.

During the negotiating period it may be necessary for the instructor to provide any mediation if groups are at a complete standstill. Another remedy to force negotiation would be to make the overall grade of the exercise be based upon a successful competition of the term sheet. This way, the groups of VCs and entrepreneurs will be forced to negotiate terms and complete the term sheet getting through minor differences. For the next class period students will provide a written paper providing the different things they considered while negotiating the term sheet and discuss the biggest issues or pitfalls they had while negotiating. Also each of the paired groups of VCs and entrepreneurs will discuss with the class what the final terms of the term sheet were for

their particular group. After the different groups discuss their negotiated terms, the instructor will provide the students with highlights of the actual final terms negotiated for this particular deal.

Before giving this assignment to students it would make sense to first have a lecture on term sheets and how term sheets are negotiated. Included within that lecture should include the natural conflicts of interest that arise due to differing objectives between VCs and entrepreneurs. The notes below will provide a good format for an overview in three different areas in which those conflicts occur. Discussing these conflicts of interest should help students in the negotiation of the term sheets.

1. Split of the financial return of the company
2. Liquidation of the company
3. Control of the company

Conflict of interest (1) occurs due to the following: The VC wants to give the entrepreneur just enough percentage of the company to keep them motivated until the liquidation event, and the entrepreneur wants to give the VC just enough percentage of the company so that the VC will choose to invest. In this way, the VC and the entrepreneur have a conflict of interest in regards to their view of the appropriate way to split the financial return of the company.

Conflict of interest (2) occurs due to the following: VCs have very precise timetable expectations of when and how they want their shares liquidated. The VCs set these timetables for the companies which they have funded. These timetables must match the timetables which were dictated by investors of the venture capital fund. The VCs and their investors agree on a length of time (generally 5 years) that the VCs have to fund companies with the investor's money. The VCs must hold the funded companies to a precise timetable because they must return the money to their investors at that previously agreed upon time. To receive funds according to their timetable, VCs can set provisions which extract value to meet their objectives. In contrast to VCs, entrepreneurs are generally involved in management of the company for a longer period. The VCs also want preference to any shareholders. In other words, VCs want their money in any liquidation event before any of the other common stockholders receive anything. The difference (between VCs and entrepreneurs) in timetables and the preferences for shareholders when there is a liquidation event of the company is a conflict of interest in regards to liquidation of the company.

Conflict of interest (3) occurs due to the following: After investing, the VC is now part owner of the company and needs to be consulted on how money is being spent. Furthermore, the VC wants rights which will ensure that management is performing well and maximizing returns. Conflict over control of the company thus naturally arises between the entrepreneur and the VC as a struggle for power over company decisions ensues. From these conflicts of interest, an inherent power struggle is created where the VC wants to minimize risk and maximize returns but the entrepreneur wants to share risk and receive the VC investments. Although the reason for deal structures is to control the conflicts of interest between VCs and entrepreneurs, the reasons for the variation in the value of deal structures includes, but is not limited to, the strength of the market, the sector of the company, the desperation of the CEO, the competition for the deal, and the stage of the company. These reasons are analyzed in depth in this dissertation. Other possible reasons for the variation in the value of deal structures which are discussed, but not analyzed, include the management team, the emotional climate of the investing community, the integrity of the VC firm, the philosophy of the fund, the stage of the fund, and the personal view of the investor. Along with discussing the conflicts of interest it will also be important to discuss the different items within a term sheet and how they work. It would be useful to provide students with the blank term sheet before this discussion.

GENERAL TERM SHEET DISCUSSION

The term sheet is a microcosm of the overall deal. The term sheet is a summary of the present understanding of the key elements and how they are going to resolve the key issues within the deal. The term sheet is non-binding. Why go through the term sheet than? The main reason is it makes transactions more efficient, and come to an agreement on some fundamental level. It is a very concise form defining what the VC is willing to do for the firm, and is followed later by legal binding agreement. The form on the NVCA web site is investor (VC) friendly. The term sheet can be broken down into three major buckets: financial, control, and miscellaneous. The financial or economic bucket considers the cash returns. This includes liquidation preference, how expensive is this funding, what returns the VC gets, price per share, valuation, and ownership shares. The control bucket includes protective provisions, representation on the board, when the founder can sell, and under what conditions can the VC force the sale.

VC has an idea of how much they want to invest, what rate of return they want, what the liquidation preference is, and what the company is going to be worth. This will let the VC back into what valuation will get them to their target rate of return. VCs demand a sufficient stock pool to incentivize the employees. An option pool is created before investment so the founders bear the full cost of incentives. Entrepreneurs want to take as little money as possible to prevent dilution. VC wants to put in as much as possible given their investment parameters. If a VC gives a high valuation they will expect the entrepreneur to give up something on the other side. With a low valuation the entrepreneur gets better liquidation preferences. With a high valuation the VC gets better liquidation preferences.

VCs typically invest in preferred stock. They get a preference when cash is paid to stock holders. In any liquidity event (payout to shareholders) they get a certain percent back. Think of cash distributions in a liquidity event as a waterfall. First are debt, taxes, liabilities, and employee benefits, followed by preferred stock and then common stock. Liquidation preference is means preferred stock gets money before common stock gets to participate. Non-participating preferred stock is where preferred stock holders get their money back plus a multiple preference. As the economy sours the multiple goes up to 3X or 4X. Typically see a 1X. Now we are seeing a movement toward 2X plus any accumulated dividends based on some rate of return. Preferred stock also has a conversion feature usually 1 to 1 for common stock. VCs like participating in preferred stock and this is the most commonly used practice. They get their preference and then they get to participate pro rata on an as converted basis. You might see a cap on preferred that limits what the VC gets. This is much more common during economic growth periods where VC investing is increasing. This idea gets more complicated as you layer in more rounds of preferred stock within additional rounds of funding. The newest funds get priority over older rounds. Early rounds face more risk so they see greater returns. Each class of preferred stock gets a different liquidation preference.

Some rights VCs have include: Anti dilution protection is insurance to investor if in future rounds goes to a lower valuation your original investment gets adjusted to a new conversion ratio. This provides a measure of protection. Less than 10% of deals have a full ratchet. Under a full ratchet the VC conversion price adjusts to the lowest price the stock is sold. Weighted average is formulated way to spread dilution due to new issues across to everyone. There are a number of instances in which anti dilution is not triggered. VCs have rights of first refusal, which means the VC can participate in any future sale. Protective provisions give VC the right to veto sale of company, issue of senior equity, no redemptions, and dividends to junior equity. Board rights give

VCs certain number of seats on the board which is very important. In early stages founders control board, but in later stages VCs control the board. The board may be split with independent third member as tie breaker.

Term Sheets Macro Market View

Less VC deals getting done in the VC market hitting the lowest in twelve years. An increasing number of later series rounds (previous investors putting more money in). Money is flowing into companies that are doing well and who need money versus speculative/start-up companies. The VC market has been seeing a lot of down rounds of financing, meaning less money going in and lower values for firms. Q2 of 2009 has seen a slight uptick in new deals, with a 15% increase over Q1. 2009 is on pass to mark the lowest year since 1997 in terms of total deals. Life science and clean tech are a few of the sectors doing well fairly well now. It is a challenging time in fund raising as well in 2009, with 63% decline year over year, the worst since the tech bubble collapsed. Small funds find it extremely hard to raise capital, and this is shown by a reduction in the number of VC firms from 1200 to 850 in the last year.

How has the current Macro Market affected VC deal and terms?

Currently entrepreneurial firms are receiving lower valuations due to economic conditions and fewer sources of liquidity. This is not a huge surprise given current market conditions as lower cash flows lead to lower valuations. Valuation is not the only important concern now. Currently we are seeing much more protective provisions (veto rights on preferences, senior preferred stock, bankruptcy and liquidity events are common) as VC seek more protection and rights if the private firm does not succeed. There are also seeing more stringent representations and warranties. From a VC point of view they want to confirm their due diligence. This gives a VC a way to sue a company (not typically done) if things do not work out. Founder representations and warranties-founder is personally liable for any violations in representations and warranties. This is not typical in West Coast deals. It is more frequent in East Coast Series A deals. It often place limits on founder's liability. Founders dislike this term but must often give in to get funding.

Pay to play has become standard helps the entrepreneur and lead investor. If this company needs subsequent capital then each member of syndicate must provide pro-rata share of capital or some terms are applied. Often the preferred stock will be converted into common stock or series A preferred stock with a less favorable liquidation preference. Smart entrepreneurs will want to raise as little capital as possible. VC is expensive capital that creates dilution in the company. In later rounds the capital is cheaper. Dividend provisions are included sometimes and other times are not included. Don't want distributions while the company grows. Many have cumulative dividends that are added to the liquidity preference. Entrepreneurs don't like this as VCs get to participate in the equity growth. The option pool is not heavily negotiated. It is the percentage (10% to 20% usually) of the company put aside to incentivize the employees. The option pool is usually done with stock options. A redemption feature is included in most term sheets.

Smaller Details within the Term Sheet

Offering terms include closing date, investors, amount raised, price per share, pre-money valuation and capitalization, found on page 3 of the term sheet. Sometimes investment is spread across multiple payments (tranches) based on achieving certain milestones. 12% of term sheets have tranches with this percentage being higher for first round financing and is more common in weak VC (post-boom) markets versus strong VC (boom period) markets. We will focus on a single

investment with no tranches. Some of the major topics on the term sheets are listed and explained below.

Value Terms Used in Term Sheets

- Price per share (also called original purchase price (OPP)) will determine how many shares the VC receives for his investment
- Aggregate purchase price (APP) is equal to OPP times number of shares purchased.
- Pre-money valuation is what the company is worth before VC investment.
- Pre-money valuation = post-money valuation - \$investment = price per share * pre-transaction (fully diluted) share count
- Post money valuation = \$investment/proposed ownership percentage.

Capitalization

The capitalization table includes all investors listed, amount invested by each investor, shares received for investment and the number of shares outstanding on a fully diluted basis. Can look at pre-money valuation and post money valuation to determine percent owned by VC. Note that VCs typically hold preferred stock that can be valued differently than common stock as it has preferences in liquidation over common stock. The capitalization table shows all the shares owned before and after the financing. This should include employee pool which is commonly call options on common stocks as incentive compensation for employees. Usually 15% of fully diluted share count. All of them are usually not issued in early rounds of financing.

Charter

The charter provides information on the dividends, liquidation preference, voting rights, protective provisions, optional conversion, anti-dilution provisions, mandatory conversion, and redemption rights. The charter (Certificate of Incorporation) is filed within state the company is incorporated (often Delaware).

Types of Payments

Dividend preference does not allow you to pay common stock dividends until the preferred stock dividends have been paid. Accrued cash dividends means that dividends are to paid in cash only upon a deemed liquidation event. Stock dividends to preferred shareholders (payment-in-kind) add to the total holding of preferred. Dividends can be cumulative or non-cumulative. Cumulative can be accrued by simple or compound interest. Liquidation preference tells the order in which you get paid (debt, preferred stock, common stock) usually more recent rounds get preference. Pari passu means that all or some preferred stock gets paid at the same time.

Voting / Shareholder Rights / Share Sales

To control voting usually two of the five board seats go to the VC, two more to the founders, and one that they both can agree on. Some actions can be blocked by a separate vote from the VCs. Anti-dilution protection protects investors if future investments are done at a lower price per share (down round). Mandatory conversion is usually on a qualified public offering exceeding some threshold of total valuation and price per share. Redemption rights allow investors to demand their investment back after a certain amount of time or failure to meet milestones. Usually the company does not have the funds to pay this if the investors are demanding it. Investor rights agreement provides information on registration rights, expenses, lock-up, registration rights termination,

management and information rights, rights to participate pro rata in future rounds, matters requiring investor director approval, non-competition and non-solicitation agreements, non-disclosure and development agreements, board matters, employee stock options, key person insurance and termination. Restricted shares cannot be sold to the public until they are registered. Registration rights means filing legal documents disclosing data about the firm to the SEC. Demand registration rights allow investor to force to register a transaction for their shares. Piggy-back registration rights allow investors to go along with a registered transaction already being prepared for other shares. Rule 144 allows shares to be sold to the public after they have been held for at least one year as long as the company has some other public shares or follows filing requirements with the SEC. Rule 144k allows unlimited sales by non-insiders of otherwise restricted stock after it has been held for at least two years. Rule 144A allows the resale of stock or debt to qualified institutional buyers (over \$100M under management) outside the registration process. Underwriters typically require a lock up of 180 days after the IPO. Management and information rights give the investor access to the management and its financial records.

Convertible Preferred Stock / Conversion Value

Different types of preferred stock include convertible preferred, redeemable preferred, participating convertible preferred and participating convertible preferred with cap. VC investment in companies is almost always some type of preferred stock investment. VC investments normally involve some type of preferred stock. Preferred stock has a liquidation preference to common stock. With convertible preferred stock the VC must decide between redeeming the preferred stock (and getting nothing else) or converting and getting its percentage of the proceeds. Investment in convertible preferred stock must consider the conversion condition and conversion point. The conversion condition is where the conversion is more valuable than the redemption. This level is called the conversion point.

Example 1:

Think of investment into a company where \$25,000,000 was used to purchase 10 million shares this represents one quarter ownership of the company. At what point is it better to convert than to redeem the shares in a liquidity event. Consider the following terms in a term sheet: In the event of any liquidation, dissolution, or winding up of the company, the proceeds shall be paid as follows: First pay one times the original purchase price on each share of series A preferred. The balance of any proceeds shall be distributed to holders of common stock. The series A preferred initially converts 1:1 to common stock at any time at option of the holder, subject to adjustments for stock dividends, splits, combinations and similar events

Suppose AAA Ventures purchased ten million shares of preferred stock for \$25 million representing one quarter ownership of the company. The liquidation preference for the preferred stock is noted previously. At what total exit proceeds should AAA convert to common stock instead of redeeming the preferred stock?

Conversion value = $\frac{1}{4}$ * exit proceeds

Exit proceeds must exceed \$100 million to make it better to convert than to redeem.

Redemption value is \$25 million

Redeemable preferred stock does not have a conversion feature. No upside if value of equity increases above conversion value. VC firms typically want to share in upside potential so they will not take only redeemable preferred stock, they might take a combination of convertible and redeemable.

Conversions Value / Order of Payoff / Antidilution Specifications

Example 2:

Consider the following terms in a term sheet: In the event of any liquidation, dissolution, or winding up of the company, the proceeds shall be paid as follows: First pay one time the Original Purchase Price on each share of Series A Preferred. Thereafter, the Series A Preferred participates with the Common Stock on an as-converted basis.

Here the shareholder gets back the original purchase price and then also receive any additional proceeds that would have been garnered if it had also converted to common stock. This only applies in the case of a liquidation event. If the PCP is converted before liquidation then it behaves just like common stock.

Example 3:

Suppose AAA Ventures purchased ten million shares of preferred stock for \$25 million representing one quarter ownership of the company. The redemption value for the redeemable preferred stock is noted on the previous example. What is the payoff to this investment?

Antidilution provisions include full ratchet and weighted average. Weighted average can be computed on a broad-base or narrow-base. Antidilution protection applies in the case of a down round. If we have an up round the VC gets to take part of the equity appreciation of the venture.

For a full ratchet consider the following terms in a term sheet: In the event that the company issues additional shares at a purchase price less than the current Series A Preferred conversion price, such conversion price shall be reduced to the price at which the new shares are issued.

The adjusted conversion rate would then be calculated as original purchase price divided by adjusted conversion price. This same calculation would occur even if the down round were for a single share.

To compute a broad-based weighted average use the following formula:

$$CP_2 = CP_1 * (A+B) / (A+C)$$

CP_1 = conversion price prior to new issue

CP_2 = conversion price after the new issue

A = shares outstanding prior to new issue

B = Aggregate consideration received by the Corporation with respect to the new issue divided by CP_1

C = new shares issued

Adjusted conversion price is applied to original VC investment to determine the total number of shares the VC owns following the issue. A includes all shares of outstanding common stock, all shares of outstanding preferred stock on as-converted basis, and all outstanding options on as-converted basis; does not include any convertible securities from this round of financing.

Narrow-Based Weighted Average

$$CP_2 = CP_1 * (A+B) / (A+C)$$

A includes all shares of outstanding preferred stock on as-converted basis, but excluding all shares of outstanding common stock and all outstanding options on as-converted basis. Both do not include any convertible securities from this round of financing. Most deals include anti-dilution provisions which are commonly the broad-based weighted average.

APPENDIX A

Handout A: Term Sheet goals for VCs

Offers of a term sheet signals that a VC is interested in investing in your company. It is not a commitment to invest. Usually if the firm signs the term sheet the VC will request a period of exclusivity to allow time to conduct a detailed due diligence during which the firm cannot look at other VCs. Due diligence follows the offering of a term sheet. Closing the deal occurs only if all parties agree to terms and valuation. The term sheet is intended to protect the minority shareholder (VC) from wealth expropriation by the majority shareholders (management). Funding is provided in sequential rounds (Series A, Series B, Series C, Etc.). Opening Information includes size of investment, parties involved, proposed capitalization. Look at pre-money valuation and post money valuation to determine percent owned by VC.

The goals of a VC which is seeking to provide funding are to (Schoar, 2002):

1. Maximize return to justify the risks and effort in funding company
2. Ensure that the company makes best use of the capital provided
3. Ensure the ability to invest in later financing rounds if it so chooses
4. Ensure the ability to liquidate their assets to match their funding cycle
5. Develop a reputation that attracts other venture opportunities

Handout B: Term Sheet goals for Entrepreneurs

Offers of a term sheet signals that a VC is interested in investing in your company. It is not a commitment to invest. Usually if the firm signs the term sheet the VC will request a period of exclusivity to allow time to conduct a detailed due diligence during which the firm cannot look at other VCs. Due diligence follows the offering of a term sheet. Closing the deal occurs only if all parties agree to terms and valuation. The term sheet is intended to protect the minority shareholder (VC) from wealth expropriation by the majority shareholders (management). Funding is provided in sequential rounds (Series A, Series B, Series C, Etc.). Opening Information includes size of investment, parties involved, proposed capitalization. Look at pre-money valuation and post money valuation to determine percent owned by VC.

The goals of an entrepreneur of a company which is seeking funding are to (Schoar, 2002):

1. Create a successful company
2. Get the funding necessary to create a successful company
3. Maintain maximum value and control of the company
4. Share the risks with the investors
5. Obtain the expertise and contacts that help the growth of the company
6. Obtain a reward for creating a successful company