Early Stage Capital: Term Sheets 101

15.391 Fall 2010
Shari Loessberg
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

Source: PWCMoneytree.com 2010
Early vs. Later Rounds

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
- PwC Moneytree & 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 $5M round =

- $15M 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?
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?
\textbf{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
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>
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## Option Pool

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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

- Starting with $200 proceeds:
- Common is left with--

  - $200
    - 50 (“VC’s preference”)
    - 75 (“VC’s participation”)

  - $75 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:

$125 total
62.5% of Co. value,
although
only 50% Co. ownership

Common gets:

$75 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 as value of company grows
- Standard
# Capped Participating Preferred

Assume $5M preferred investment for 50% of Company

<table>
<thead>
<tr>
<th>Sale of Company @</th>
<th>No Cap</th>
<th>3X Cap</th>
<th>Convert to Common</th>
<th>VC’s Choice if capped</th>
</tr>
</thead>
<tbody>
<tr>
<td>$12M</td>
<td>$8.5M (5 + 3.5)</td>
<td>$8.5M* (5 + 3.5)</td>
<td>$6M</td>
<td>Preferred</td>
</tr>
<tr>
<td>$40M</td>
<td>$22.5M (5 + 17.5)</td>
<td>$20M (5 + 15)</td>
<td>$20M</td>
<td>Indifferent</td>
</tr>
<tr>
<td>$41M</td>
<td>$23M (5 + 18)</td>
<td>$20M (5 + 15)</td>
<td>$20.5M</td>
<td>Convert</td>
</tr>
<tr>
<td>$225M</td>
<td>$115M (5 + 110)</td>
<td>$20M (5 + 15)</td>
<td>$112.5M</td>
<td>Convert</td>
</tr>
<tr>
<td>$1005M</td>
<td>$505M (5 + 500)</td>
<td>$20M (5 + 15)</td>
<td>$502.5M</td>
<td>Convert</td>
</tr>
</tbody>
</table>
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?
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?
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--
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