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23 Sept 2014
Bangalore, India

Components of Term sheet

NOT A LEGAL PROMISE TO INVEST- intent to invest subject to fulfillment of conditions and due diligence

- Economics
  - Valuation
  - instrument
  - Dividend
  - Liquidation preference
  - Option pool
  - Anti dilution etc
- Control
  - Participation rights
  - Tag along
  - ROFR
  - Drag along
  - Voting rights
  - Board representation
  - Information rights etc

Price

- Valuation of the company in a priced round
  - Pre money : valuation before the money comes in
  - Post money: valuation of the company just after money comes in

800,000 + 200,000 = 1,000,000 if an investor takes 20% of the company with 200K investment

Sample Language

- "**Amount of Financing**: *An aggregate of $ X million, representing a __% ownership position on a fully diluted basis, including shares reserved for any employee option pool. Prior to the Closing, the Company will reserve shares of its Common Stock so that __% of its fully diluted capital stock following the issuance of its Series A Preferred is available for future issuances to directors, officers, employees and consultants.*
- *Price: $______per share (the Original Purchase Price). The Original Purchase Price represents a fully-diluted pre-money valuation of $ __million and a fully-diluted post money valuation of $__ million. For purposes of the above calculation and any other reference to fully-diluted in this term sheet, fully-diluted assumes the conversion of all outstanding preferred stock of the Company, the exercise of all authorized and currently existing stock options and warrants of the Company, and the increase of the Company's existing option pool by [ ] shares prior to this financing.*

Instrument

- Pure Equity- Rare
- Pure Debt- medium-rare
- Convertible debt- medium
- Convertible Preference shares- well done

Foreign Equity Investors: Priced Round
Indian Non VC investors: Angel Tax
Optionally Convertible Debentures: setting up of independent trust, money to be held in it and the company creating reserves for debenture redemption

Stock Option

- Shares set aside for current or future employees so that they stay committed to long term growth of the company.

Sample Language

- *“Employee Pool: Prior to the Closing, the Company will reserve shares of its Common Stock so that __% of its fully diluted capital stock following the issuance of its Series A Preferred is available for future issuances to directors, officers, employees and consultants. The term “Employee Pool” shall include both shares reserved for issuance as stated above, as well as current options outstanding, which aggregate amount is approximately _ % of the Company’s fully diluted capital stock following the issuance of its Series A Preferred.”*

- Each investor wants to ensure that they get the ESOP pool created before investment – avoids dilution of investor for this pool.
- Legally – one needs to set aside these shares in a trust, most investors would work on a gentleman’s agreement.
- **How do unutilized options extinguish?**

Liquidation

The right of the investor to get the share of proceeds before anyone else takes away the money

Sample Language

- *Liquidation Preference: In the event of any liquidation or winding up of the Company, the holders of the Series A Preferred shall be entitled to receive in preference to the holders of the Common Stock a per share amount equal to [x] the Original Purchase Price plus any declared but unpaid dividends (the Liquidation Preference).*

- Liquidation includes acquisition , asset sales etc
- Investor wants to ensure that the money is returned to her before anyone else including friends and family
- Preference is subordinated to debt.
- **Typically non negotiable**
- **Most benevolent is 1X, people do take 2X or 3X**

Participation

Does the investor gets more money as if they held proportionate shares in the companies after the liquidation preference is satisfied.

Full Participation: there is no limit to the proceeds that investor gets

- *Participation: After the payment of the Liquidation Preference to the holders of the Series A Preferred, the remaining assets shall be distributed ratably to the holders of the Common Stock and the Series A Preferred on a common equivalent basis.*

Capped Participation: there is a limit to the proceeds that investor gets

- *After the payment of the Liquidation Preference to the holders of the Series A Preferred, the remaining assets shall be distributed ratably to the holders of the Common Stock and the Series A Preferred on a common equivalent basis; provided that the holders of Series A Preferred will stop participating once they have received a total liquidation amount per share equal to [X] times the Original Purchase Price, plus any declared but unpaid dividends. Thereafter, the remaining assets shall be distributed ratably to the holders of the Common Stock.*

Investor wants to ensure that they share an upside

- Pure Debt is non participative
- **Typically non negotiable?**

How does it work

Investor Invests 50 lakhs in the company for 10% stake in the company at a 1X . The company takes 10L as debt

Scenario	Liquidation Proceed	Debt Repayment	Investor's share (1X participative)	Other shareholders get
Ugly	50	10	40	0
Mediocre	200	10	64	126
Good	1000	10	144	846

Dividend

What does the investor get if dividend is declared by the company.

- *"Dividends: The holders of the Series A Preferred shall be entitled to receive [non-]cumulative dividends in preference to any dividend on the Common Stock at the rate of [8%] of the Original Purchase Price per annum[, when and as declared by the Board of Directors]. The holders of Series A Preferred also shall be entitled to participate pro rata in any dividends paid on the Common Stock on an as-if-converted basis."*

- Investor wants to ensure that they share in profit distribution
- Most lawyers suggest preferential dividend
- Cumulative- accumulate even when it is not declared-similar to interest
- **Not the most important thing. So expect a notional preferential dividend**

Tag Along

If promoters (not company) sell shares, investor also wants to sell them

- *"Co-Sale Agreement: The shares of the Company's securities held by the Founders shall be made subject to a co-sale agreement (with certain reasonable exceptions) with the Investors such that the Founders may not sell, transfer or exchange their stock unless each Investor has an opportunity to participate in the sale on a pro-rata basis. This right of co-sale shall not apply to and shall terminate upon a Qualified IPO."*

- Investors don't like promoters exiting, fully or partially
- **If promoters sell more than 50% of their holding, expect investors to seek complete exit**
- **Non negotiable**

Drag Along

- Investor find a suitable buyer, buyer wants more shares and investor is forcing others to sell

- *"**Drag-Along Agreement**: The [holders of the Common Stock] or [Founders] and Series A Preferred shall enter into a drag-along agreement whereby if a majority of the holders of Series A Preferred agree to a sale or liquidation of the Company, the holders of the remaining Series A Preferred and Common Stock shall consent to and raise no objections to such sale."*

- **Depends on size of transaction- negotiate**
- **Compromises can be reached**
-

Vesting

Investors want to ensure that the promoters stay in the company for a significant time after the investment is made

- *Stock Vesting: All stock and stock equivalents issued after the Closing to employees, directors, consultants and other service providers will be subject to vesting provisions below unless different vesting is approved by the majority (including at least one director designated by the Investors) consent of the Board of Directors (the "Required Approval"): 25% to vest at the end of the first year following such issuance, with the remaining 75% to vest monthly over the next three years. The repurchase option shall provide that upon termination of the employment of the shareholder, with or without cause, the Company or its assignee (to the extent permissible under applicable securities law qualification) retains the option to repurchase at the lower of cost or the current fair market value any unvested shares held by such shareholder. Any issuance of shares in excess of the Employee Pool not approved by the Required Approval will be a dilutive event requiring adjustment of the conversion price as provided above and will be subject to the Investors' first offer rights.*

The outstanding Common Stock currently held by _ and _ (the "Founders") will be subject to similar vesting terms provided that the Founders shall be credited with [one year] of vesting as of the Closing, with their remaining unvested shares to vest monthly over three years.

- Investors don't like promoters exiting, fully or partially
- **Some upfront vesting and quarterly vesting over 3-4 years**
- **If you are completely new- one year cliff**
- **Negotiable, but removal is not worth fighting for**

Protective Provisions

NO HANKY PANKY

- *"Protective Provisions: For so long as any shares of Series A Preferred remain outstanding, consent of the holders of at least a majority of the Series A Preferred shall be required for any action, whether directly or though any merger, recapitalization or similar event, that (i) alters or changes the rights, preferences or privileges of the Series A Preferred, (ii) increases or decreases the authorized number of shares of Common or Preferred Stock, (iii) creates (by reclassification or otherwise) any new class or series of shares having rights, preferences or privileges senior to or on a parity with the Series A Preferred, (iv) results in the redemption or repurchase of any shares of Common Stock (other than pursuant to equity incentive agreements with service providers giving the Company the right to repurchase shares upon the termination of services), (v) results in any merger, other corporate reorganization, sale of control, or any transaction in which all or substantially all of the assets of the Company are sold, (vi) amends or waives any provision of the Company's Certificate of Incorporation or Bylaws, (vii) increases or decreases the authorized size of the Company's Board of Directors, or (viii) results in the payment or declaration of any dividend on any shares of Common or Preferred Stock, or (ix) issuance of debt in excess of $100,000."*

- **Understand that these are protective**
- **Brings clarity to roles**
- **No investor wants to run the company for you. If they wanted, they would be entrepreneurs.**
- **Negotiate on specifics but don't be stubborn**

Board of directors

So that the investor has a say in strategic direction of the company.

- *Board of Directors: The size of the Company's Board of Directors shall be set at [n]. The Board shall initially be comprised of ___________, as the Investor representative[s] ______________, ________________, and _____________. At each meeting for the election of directors, the holders of the Series A Preferred, voting as a separate class, shall be entitled to elect [x] member[s] of the Company's Board of Directors which director shall be designated by Investor, the holders of Common Stock, voting as a separate class, shall be entitled to elect [x] member[s], and the remaining directors will be [Option 1: mutually agreed upon by the Common and Preferred, voting together as a single class.] [or Option 2: chosen by the mutual consent of the Board of Directors].*
- **Some investors would take board observer seats**
- **Don't supersize the board**
- **Negotiate on specifics but don't be stubborn**

Conditions Precedent

Things to be done before investment happens

- *"Conditions Precedent to Financing: Except for the provisions contained herein entitled "Legal Fees and Expenses", "No Shop Agreement", and "Governing Law" which are explicitly agreed by the Investors and the Company to be binding upon execution of this term sheet, this summary of terms is not intended as a legally binding commitment by the Investors, and any obligation on the part of the Investors is subject to the following conditions precedent: 1. Completion of legal documentation satisfactory to the prospective Investors; 2. Satisfactory completion of due diligence by the prospective Investors; 3. Delivery of a customary management rights letter to Investors; and 4. Submission of detailed budget for the following twelve months, acceptable to Investors."*

- **"Satisfactory Completion of due diligence" is standard**
- **"approval by investor partnership" is a red flag**
- **"employment terms for the founders" please get details.**

Anti dilution

What happens if you issued shares to james at 10 per share and in 6 months at 1 per share to me- James invokes anti dilution. Protecting him from Hanky panky

- *Anti-dilution Provisions: The conversion price of the Series A Preferred will be subject to a [full ratchet / broad-based / narrow-based weighted average] adjustment to reduce dilution in the event that the Company issues additional equity securities (other than shares (i) reserved as employee shares described under the Company's option pool,, (ii) shares issued for consideration other than cash pursuant to a merger, consolidation, acquisition, or similar business combination approved by the Board; (iii) shares issued pursuant to any equipment loan or leasing arrangement, real property leasing arrangement or debt financing from a bank or similar financial institution approved by the Board; and (iv) shares with respect to which the holders of a majority of the outstanding Series A Preferred waive their anti-dilution rights) at a purchase price less than the applicable conversion price. In the event of an issuance of stock involving tranches or other multiple closings, the antidilution adjustment shall be calculated as if all stock was issued at the first closing. The conversion price will also be subject to proportional adjustment for stock splits, stock dividends, combinations, recapitalizations and the like.*
- Full ratchet- all shares assumed to be of INR 1 value
- Weighed average considers the magnitude of the round as well.
- **Take weighted average anti dilution if you get it**

Information Rights

We want to know what is happening, in a form that we understand

- *"Information Rights: So long as an Investor continues to hold shares of Series A Preferred or Common Stock issued upon conversion of the Series A Preferred, the Company shall deliver to the Investor the Company's annual budget, as well as audited annual and unaudited quarterly financial statements. Furthermore, as soon as reasonably possible, the Company shall furnish a report to each Investor comparing each annual budget to such financial statements. Each Investor shall also be entitled to standard inspection and visitation rights. These provisions shall terminate upon a Qualified IPO."*

Please inform us of any important development

Give us information on a regular basis

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Please....

Others

- Founders Activities
- Initial Public Offering Shares Purchase
- No Shop Agreement
- Indemnification
- Assignment
- Restriction on Sales
- Proprietary Information and Inventions Agreement

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