MICHIGAN ROSS

Winter 2025

FIN 623: Venture Capital Finance

Term Sheets and Cap Tables

Plan for today

Part I: Term Sheets & Cap Tables

Part II: Preferred Stock

Part III: Anti Dilution Provisions

Part IV: Other Securities

Part I: Term Sheets & Cap Tables

What Do Entrepreneurs Care About?

- Build a successful business
- Raise enough money to fund the startup
- Maintain as much value and control of the company as possible
- Get expertise and contacts to grow the company
- Share some of the risks with investors
- Financial rewards if the company does well

What Do VCs Care About?

- Maximize financial returns to justify the risk and effort involved in funding a company
- Ensure that the company is using investment funds in the best possible way
- Participation in later financing rounds if the venture is a success
- Eventually achieving “liquidity” (exit!)
- Raise more money!

Overlapping Interests

- VCs and entrepreneurs both care about:
  1. Success of the new venture
  2. Split of financial returns
  3. Allocation of control rights
  4. Eventually liquidating some or all of their stake in the company

- What are potential conflicts of interest?

Simple Financial Securities

- Do simple financial securities meet the needs of VCs and entrepreneurs?

- Common stock
  - Returns?
  - Control?
  - Liquidity?

- Debt
  - Returns?
  - Control?
  - Liquidity?

Contracts between VCs and Entrepreneurs

- Financial returns divided to:
  - Reward investors for their investments in the firm
  - Provide high-powered incentives to entrepreneurs to maximize value and stay with the firm
  - Provide VCs with incentives to add value

- Dynamic allocation of control:
  - More control to entrepreneur if things turn out well
  - More control to VC if things do not turn out well

- Provides incentives to achieve a liquidity event

What is a Term Sheet?

- VC fund signals intention to invest by offering a term sheet to potential portfolio company

- Portfolio company responds by:
  - Signing the term sheet
  - Rejecting it completely
  - Negotiating the term sheet

- After signing, VC conducts detailed due diligence
  - Usually period of exclusivity

What's in a Term Sheet?

Three main parts:

- Offering Terms
  - Key terms for investment, including investment amount and list of all investors and ownership (cap table)
  - Provides post- and pre-money valuations
- Charter
- Investor Rights Agreements

Offering Terms

- Term sheets begin with the offering terms

- Lists key terms for investment
  - Critical for decision by VC fund and entrepreneur

- Includes the investors in the current financing round
  - Capitalization provide list of all investors

- Amount of investment
  - Includes number of shares and proposed ownership percentage

Offering Terms: Valuation

- Term sheet provides post- and pre-money valuation
  - Post-money valuation equals investment in financing round / Proposed ownership (%)
  - Pre-money valuation equals post-money valuation minus investment in financing round

- Fully diluted share count
  - Total shares outstanding
  - Changes in financing round since equity sold to investors

Example of Capitalization Table

	Pre-Financing		Post-Financing	
Security	# of Shares	Ownership (%)	# of Shares	Ownership (%)
Common – Founders	7,750,000	77.5	7,750,000	51.7
Common – Employee Stock Pool	2,250,000	22.5	2,250,000	15.0
Issued	300,000	3.0	300,000	2.0
Unissued	1,950,000	19.5	1,950,000	13.0
Series A Preferred	0	0.0	5,000,000	33.3
Total	10,000,000	100	15,000,000	100

- Commonly called “cap table”
- Details ownership before and after financing
- Highlights effect of investment on dilution

The Charter

- Also called certificate or articles of incorporation
- Provides rights and privileges for securities
- Main area for provisions negotiated!
- Can be viewed as VCs (minority shareholders) protecting themselves from expropriation by majority shareholders
- Detailed by each class of shares (common, preferred) and each series of stock (Series A, Series B, . . .)

Charter Provisions

Dividends to Holders of Prefeffed Shares	Describes how dividends will accrue to preferred shareholders and timing and conditions under which
Liquidation Preference	Describes the order of payment of proceeds from liquidation, such as first return the proceeds invested by preferred shareholder, then pay preferred dividends, then pay common dividends, then share the balance pro rata.
Prefeffed Stock Voting Rights	Such as voting on an as converted basis and the right to vote separately to elect a specified number of directors.
Conversion Rights	Such as the right to convert to common at any time, adjusted for accrued preferred dividends.
Anti-Dilution Provisions	Such as a right to retain ownership share or a full or partial ratchet provision, and conditions under which the provision would not apply, such as a conversion of the preferred shares.
Mandatory Conversion	Conditions under which a public offering of the venture would force conversion of the preferred shares.
Pay-to-Play Provision	Requirement for preferred investors to participate in down rounds or convert to common or lose some preferred rights.
Redemption Rights	Right of preferred investors as a group to demand redemption of investment from available funds.

The Charter: Dividends

- Often includes dividend preference
  - Cannot pay any dividends to common stock unless you first pay dividends to preferred stockholders
  - Prevents managers from expropriating cash to common shareholders

Two types of dividends:

- Accrued cash dividends
  - Dividends paid only after an exit

- Stock dividend
  - Called payment-in-kind ("PIK") preferred
  - Provides additional shares of the preferred stock

The Charter: Liquidation Preference

- When a liquidation event occurs, proceeds are distributed according to rules
  - Provides an ordering who gets paid first
  - Liquidation event is usually when company, sold, merged, or shut down

- Seniority is very important!
  - Latest-round investments commonly paid first (about two-thirds of deals)
  - “Pari passu”: Paid back at the same time

- Investors sometimes require liquidation preferences in excess of original investment
  - About 25% of deals contain these provisions and about 70% are 2X or less

The Charter: Voting Rights

- Provides protection to VC funds (minority shareholders)
  - Often includes board seats
  - At Series A, often split with investors
  - In later rounds, investors tend to control the board
- Right to prevent corporate actions, such as major investments
- Highlights VC fund's involvement with corporate governance of portfolio company

Investor Rights Agreements

- Provides many of the legal and technical details about the preferred stock

Main parts are:

- Registration rights
  - Details how to force the company to exit
- Matters requiring investor-director approval
  - Protect investors from managers
  - Lists items specifically in term sheet
  - Trade-off between protecting investment and allowing portfolio company to grow
- Employee stock options
  - How much and limits to growth
  - Vesting schedules

Other Items

- Term sheets contain several other sections:
  - Stock purchase agreement
  - Right of first refusal
  - Other provisions

- Rights to participate in future rounds
  - Referred to as “right of first refusal”
  - Investors have this real option
  - “Pro rata” is at rate of current ownership

- Restrictions on founders exiting in “sweetheart deal”
  - Prevents founders from exiting too quickly

Example of Typical Term Sheet

- A typical term sheet is available on Canvas and related documents at NVCA Term Sheet

Part II: Preferred Stock

What's Wrong With Common Stock?

- Common stock is usually used by public firms
- Subordinated to other claims: Common stockholders paid last!
- VCs do not use common stock
- Let's consider the following example:
  - Suppose that you accept a $1.5 million investment by VC fund for 49.9% ownership
  - Your classmate is a senior VP and offers you $2 million for your firm
  - What do you do?

Example Net Proceeds

Features of Preferred Stock

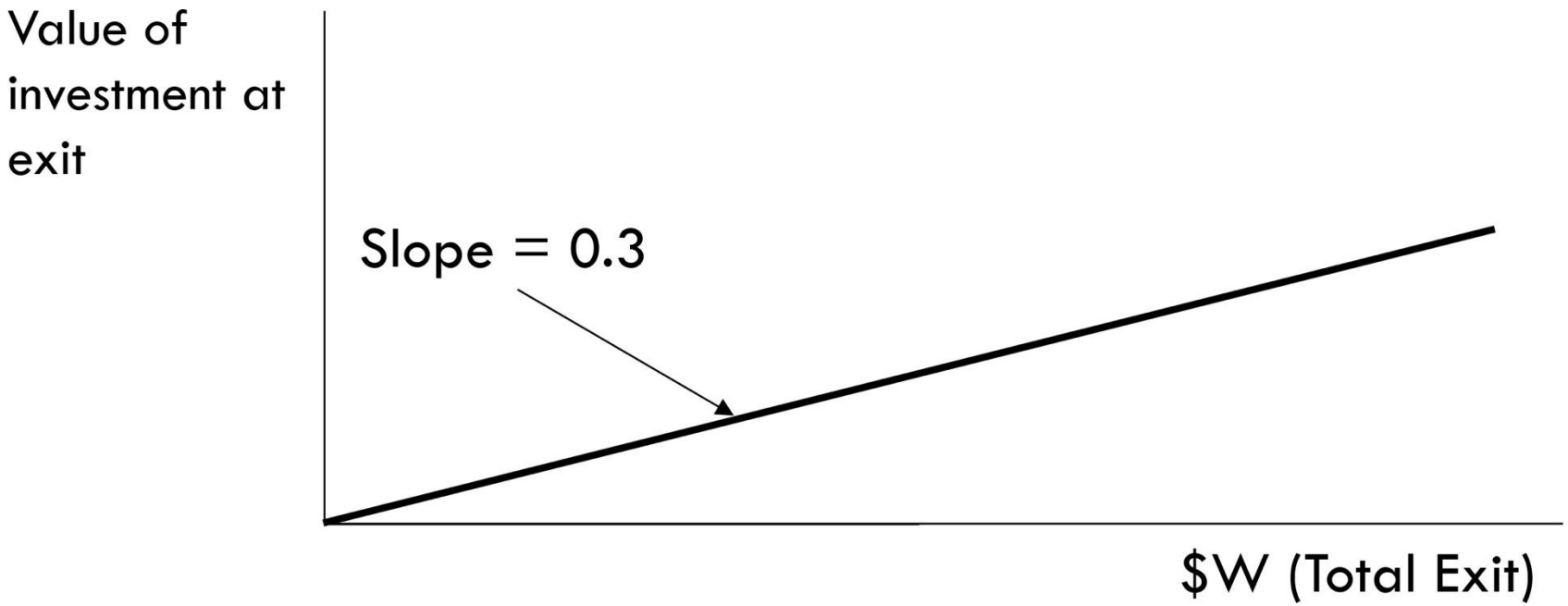
- Many types of preferred stock!

- Shared feature: Liquidation preference over common stock
  - Receive (at least!) investment proceeds before common stockholders paid
  - Provides downside protection

- VC often require upside participation
  - Convertible into common stock

Exit Diagram

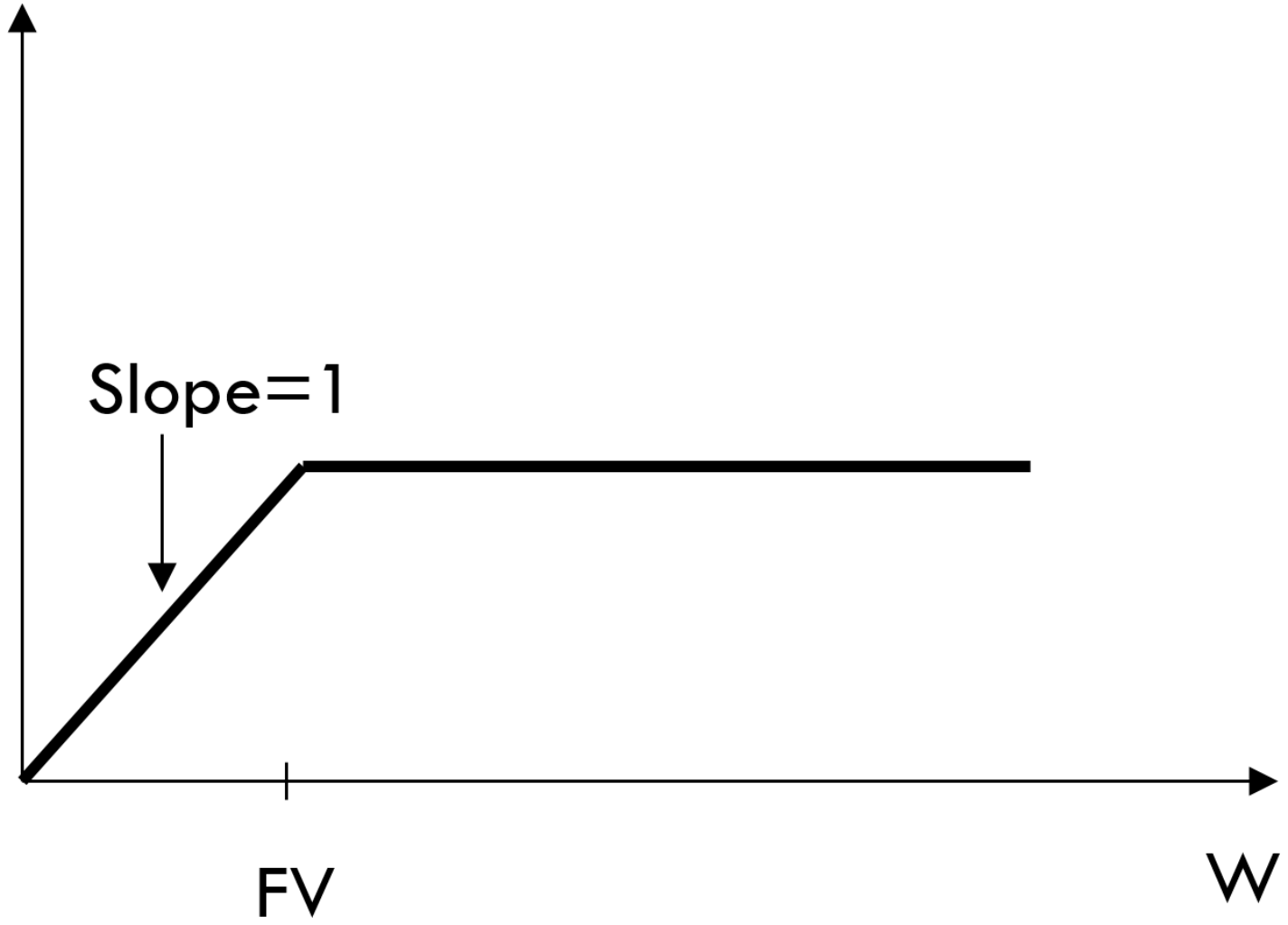
- Exit diagrams plots value of a security (y-axis) against value of the firm (x-axis) at the time of exit
- Example: 30% ownership in an all-equity company (no debt, no preferred stock)



Redeemable Preferred (RP)

- Liquidation preference over common stock
- Not convertible into common stock
- Dividends can accrue (added to face value), but not typically paid prior to redemption
- VC never includes just redeemable preferred
  - Require upside participation, in addition to downside protection

Exit Diagram for Redeemable Preferred



Redeemable Preferred with Common Stock

- Redeemable preferred is often packaged with common stock
- Liquidation preference provides downside protection
- Common stock is upside participation

Benefits of RP with Common Stock

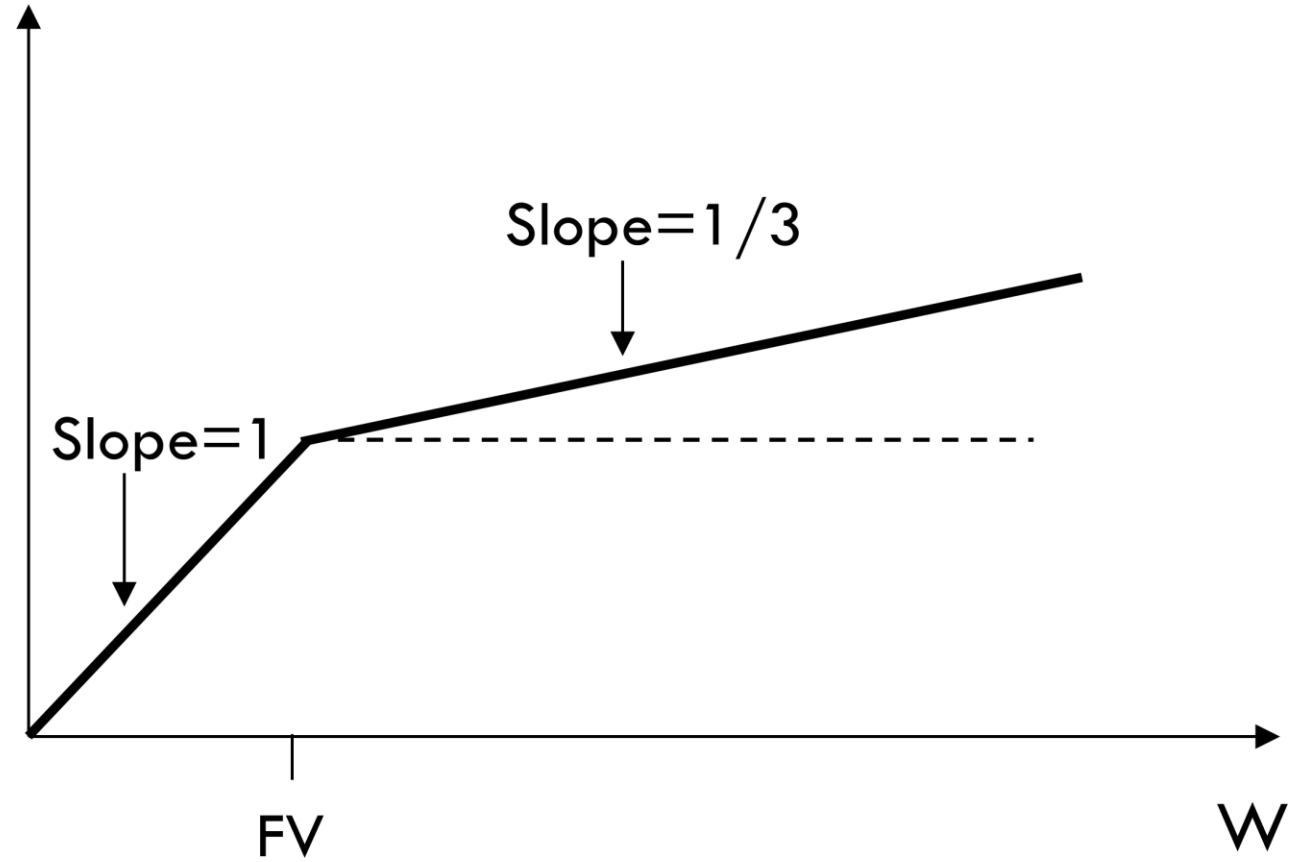
- Prevents founders from being able to pull out money before they create any real value

- Redemption of preferred is just return of capital, thus no capital gains tax

- Specifies when it must be redeemed by company
  - Typically the sooner of IPO or 5 to 8 years
  - Prevents “life-style company”

Exit Diagram for RP with Common Stock

- Example: Redeemable preferred and common stock for one-third ownership



Convertible Preferred (CP)

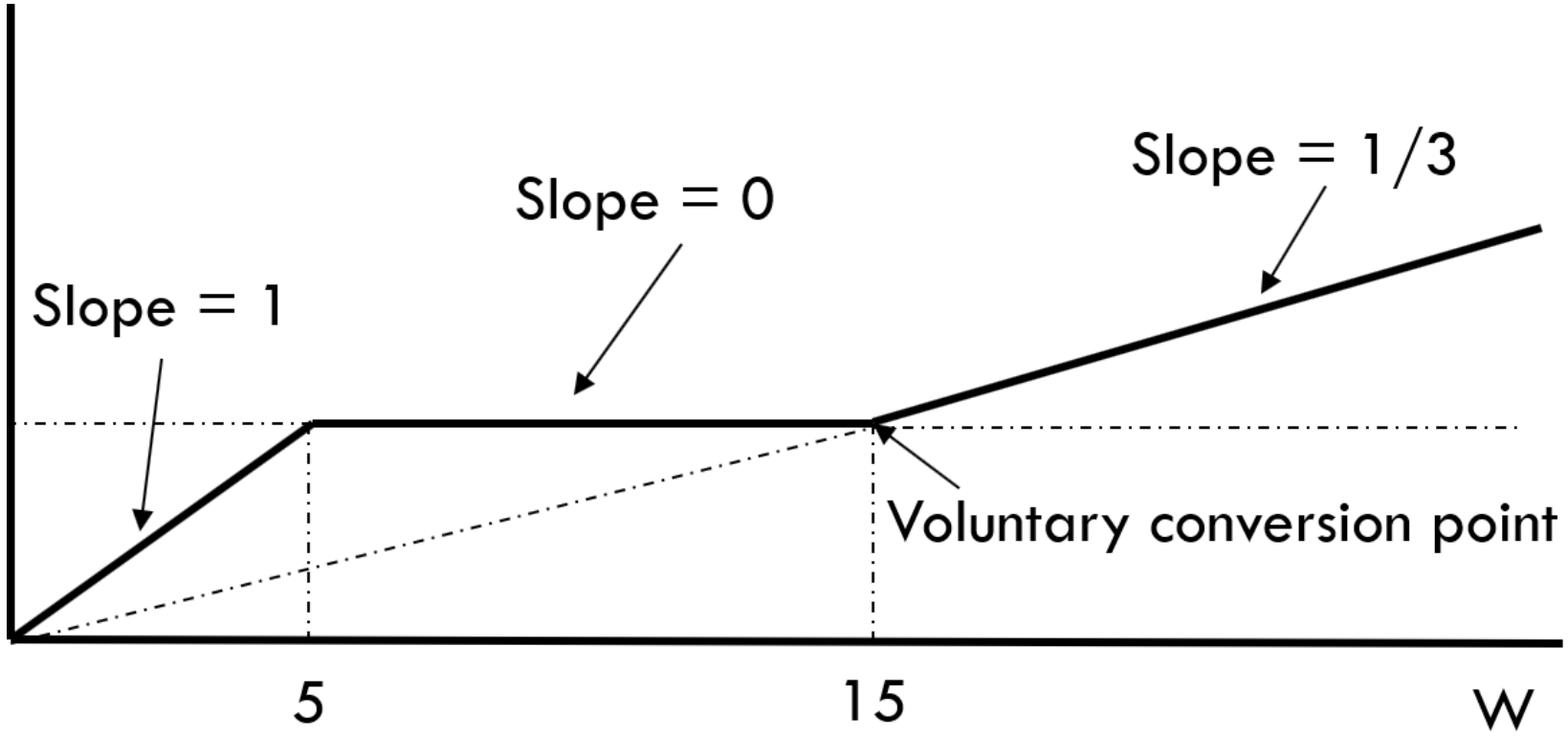
- Can convert redeemable preferred into common stock at a pre-specified conversion price
- Provides incentive for large exits
- Allows entrepreneur to catch-up to the VC fund after they receive back initial investment
- About 80% of VC investment are a form of convertible preferred

Conversion of CP into Common Stock

- Determines when it is more valuable to convert to common stock than to redeem
- Conversion condition: Convert if ownership times exit value is greater than liquidation preference (with accrued dividends)
- Most include automation conversion at IPO if the price is above a certain pre-specified amount (qualified IPO)

Exit Diagram for Convertible Preferred

- Example: Convertible preferred of $5 million with an option to convert to 5 million shares
  - 10 million shares of common stock



Participating Convertible Preferred (PCP)

- Compromise between the RP + common structure and the more stringent CP structure
  - Now most frequently used type of preferred stock

- Convertible preferred with extra feature that “in the event of liquidation or sale” the holder gets face value plus equity participation.
  - Redeemable preferred + common stock if the company is liquidated (sold). In our example, would get $5M and 1/3 of the company.
  - Convertible preferred if company goes public. In our example, would get $5M or 1/3 of the company.

- Automatic conversion to common stock if qualified IPO (QPO)

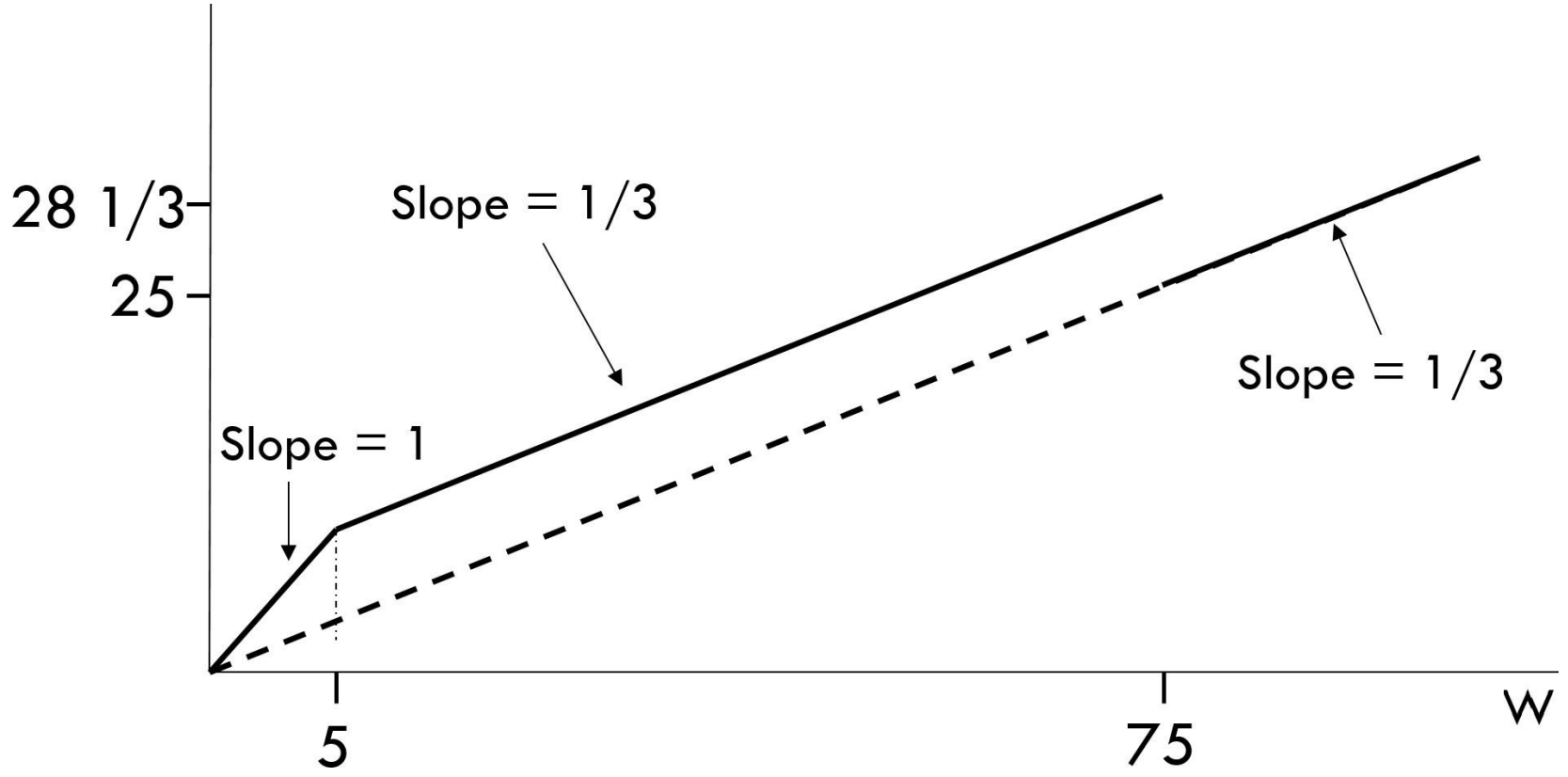
QPO and Automatic Conversion

- Qualified public offering is an IPO with minimum offering price and minimum total offering proceeds or market cap

- Why include automatic conversion provision?
  - Founders demand automatic conversion to facilitate IPO because otherwise an IPO requires approval of preferred stockholders
  - VCs want to set the QPO requirement high enough to prevent founders from pushing the firm public too early

PCP Exit Diagram

- Example: Participating convertible preferred of $5 million and can convert to 5 million shares, QPO set at $75 million



- QPO threshold: $\$5M + \frac{1}{3} \times (\$75M - \$5M) = \$28\frac{1}{3}M$

Example of Common vs. Preferred Stock

- VC invests $5 million for 50% of startup

Exit Value	Common Stock	Convertible Preferred	Participating Convertible Preferred
$8M			
$13M			
$200M			

Does It Matter?

- Complicated payoff structures with different securities

- No, in the world of Modigliani-Miller!
  - Just alternative ways to divide up the pie (company value)

- Yes, in the real world!
  - High-powered incentives for VC to add value
  - High-powered incentives for entrepreneurs to create long-term value

The Role of Preferred Stock

- Preferred feature aligns incentives of entrepreneur with VC to strive for large payoffs
  - Limits returns to the founder for modest outcomes - incentives to reach high payoffs
  - Protects later-stage investors who come in at a high valuation relative to A-round
- VC can incentivize entrepreneur to go for the big payoffs with the choice of a specific security
- Need to be careful that entrepreneur feels options are “in the money”

Part III: Anti Dilution Provisions

Antidilution Provisions

- Protect investors from loss of value in the event that the next investment round is a *down round:*
  - Down Round: financing round in which a company sells shares at price lower than in an earlier financing.
  - Flat Round: financing round in which the price per share sold by a company doesn't change compared to the previous round.
  - Up Round: financing round in which a company sells shares at price higher than in an earlier financing.

- In case of a down round, the previously protected investors have the right to convert their preferred shares into common stock at a higher conversion rate if provided in the term sheets.

- 3/4 of term sheets have an anti-dilution provision

Down Rounds

Estimated proportion of down rounds hits 10-year high of 17.1%

Quarterly share of VC deals by round type

Source: PitchBook • **Geography:** US
*As of September 30, 2023

Full Ratchet Antidilution

- Definition: Adjusts the conversion price of preferred shares to match the lowest price of new shares issued (down round price).
- Mechanism: Investor converts preferred shares as if they paid the lower price, increasing the number of common shares they receive.
- Example:
  - Initial: 1M shares @ $10 → Converts to 1M common shares.
  - Down Round: Shares issued @ $5 → Converts to 2M common shares.
- Impact: Strong investor protection but significantly dilutes founders and other common shareholders.

Weighted Average Antidilution

- **Definition:** Adjusts the conversion price of preferred shares based on a weighted formula considering the number of new shares issued and their price.
- **Mechanism:** Balances protection for investors and limits dilution for existing shareholders compared to full ratchet.
- **Formula:**

$$\frac{\text{Old Conversion Price} \times \text{Outstanding Shares (Pre-Issue)} + \text{Issue Price} \times \text{New Shares Issued}}{\text{Outstanding Shares (Pre-Issue)} + \text{New Shares Issued}}$$

- **Example:**
  - Initial: 1M shares @ $10.
  - New: 500K shares @ $5.
  - New Conversion Price $= \frac{10\times1{,}000{,}000+5\times500{,}000}{1{,}000{,}000+500{,}000} = \frac{12{,}500{,}000}{1{,}500{,}000} \approx 8.33$
- **Impact:** Reduces dilution for founders compared to full ratchet while providing fair protection for investors.

Antidilution Provisions in Practice

- Full-ratchet antidilution are popular during downturns

- Misleading to take the mechanical security of full-ratchet (and other) antidilution provision at the face value

- Why?
  - Negotiable terms, especially if previous VC wants the new financing round
  - New investors often ask to waive these protections
  - Who has bargaining power?

Part IV: Other Securities

Choice of Securities

- Common stock: % Control (Voting Rights) = % Payoff = % Invested Capital
  - Does not grant downside protection for investors
  - Provide linear rather than exponential incentives for entrepreneurs to perform
  - Economic interests go in tandem with control features

- Preferred stock: : % Control (Voting Rights) ≠ % Payoff ≠ % Invested Capital
  - Grant downside protection for investors
  - Provide exponential rather than linear incentives for entrepreneurs to perform
  - Economic interests are separated from control features

- Overview of other types of (less common) securities

	Venture Debt	Convertible Debt	Working Capital Line
Description	A non-convertible, senior term loan that can be used like equity, and includes warrants	A loan that converts to stock in the next equity round, usually at a discount or with warrants	A revolving line of credit that is secured by working capital; may or may not include warrants
Repayment	Generally repaid in monthly payments over the life of the loan	None, converts to equity	Can flex up or down over the life of the loan, depending on the "borrowing base" securing the loan
Approximate Interest Rate	10-15%	3-8%	6-10%
Dilution	Generally a small fraction of equity (< 1%), due to warrants	Similar to equity, but can be more or less dilutive depending on valuation in the next round and specific terms	Minimal to none; may or may not include warrants.
Default Clauses	Varies, but often limited to failure to repay	Generally none	Often includes MAC catch-all (any "material adverse change"), investor abandonment, etc.
Financial Covenants	Generally none	Generally none	Often bound to a minimum amount of cash, A/R, performance vs. plan, etc.

Warrants in Venture Capital

- Warrants are securities that give the holder the right (but not the obligation) to purchase company stock at a specified price within a specific period.

- Example:
  - A venture debt lender provides Company A with a $3 million loan with 10% warrant coverage. Company A issues a warrant to the lender for $300,000 worth of shares in the company with an expiry date of 5 years.
  - The lender now holds a warrant that allows them to invest $300,000 to buy shares of Company A at the price of Company A's most recent financing round on or before the expiry date.

- Warrants typically only translate to 1-2% of the company if executed.

- This is significantly lower than the dilution associated with VC funding and only applies if the venture debt lender decides to exercise them. If they do decide to exercise their warrants, they will still need to pay to purchase those shares.

Next: VC Firms and Funds