Transcription

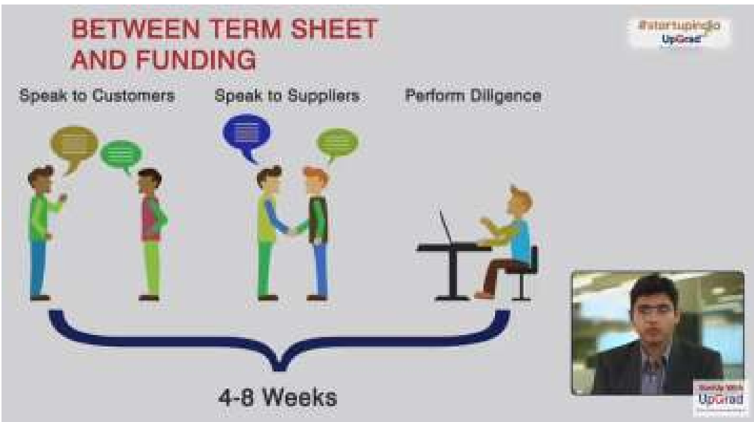
Term sheet & Post-term sheet

Introduction – Term sheet & Post-term sheet

Hi, good to see you for this session. So as we draw to a close with the Start-up with Upgrad program, we've gone through various modules which I hope you are implementing in your business idea across idea validation, scaling up, business model differentiation, funding etc. Finally one of the very important things when it comes to closing the deal with investors is understanding term sheets. Carefully understanding the various terms and clauses of a term sheet is important to make sure that both the parties involved– the entrepreneur as well as the investor are on the same page and understand their roles and are happy with the term sheet. Let's hear from Tarun Davda of Matrix partners to understand this further.

So I think one of the biggest milestones for an entrepreneur as in the overall funding process is the term sheet. I think the term sheet is the first validation that an investor actually is interested and is the first sort of show of confidence in the entrepreneur and in the business they are trying to build.

I think the way to think about the term sheet is it is not a formal contract, it is more of an expression of interest, it's a letter of intent, it's a handshake that you are doing between the investor and the founders saying that we have enjoyed our interactions with you so far, we have met your team, we have analysed your data, we understand your business and subject to certain things being met we would like to proceed with funding the company they do a little bit more diligence on the business.



So maybe they will speak to a customer, understand how the product is working for them, they may speak to some of your suppliers, they may do commercial diligence or financial diligence, legal diligence, typically this process takes somewhere 4-8 weeks. But unless there are any negative surprises that come out in this process, you should assume that the company will get funded, at least if you are interacting with a quality investor.

The reality is like any other contract. This involves negotiation. The investor will typically draft the first version of the shareholder's agreement or the share subscription agreement, they will send it you. It is generally in line with the term sheet, so the key terms in the broad sort of contours of the documents have already been agreed upon. This is basically taking each of those to the next level of detail and being drafting in legal language. So like everything else this is a negotiation, there will be some give and take in the process and you should at the earlier stage, the day you got in term sheet involve a lawyer who you trust, who is independent of the lawyer that the investors may appoint to help guide you especially if you are doing it for the first time.

Components of a Term Sheet (i)

In the term sheet, in a formal communication of offer of funding to you, you will get a term sheet. In that term sheet there are some 15-16 different clauses and each of those clauses might be as or more important than just the number of funding and the dilution which you are getting. So you should look at the whole package that's one and not just that one number looks at all the legal clauses, all the other commercial clauses which are there in the term sheet. But also you should look at who are you partnering with in the investor. Is he an investor who will work with you for long period of time because a business goes on for 10 years, 12 years, 15 years and you have to work with the investor for long period of time so what is he bringing to the table, is he a helpful investor. Some other investor might be giving you a very high valuation, lot of money but he will want you to work according to what he wants whereas this investor who will give you a lot of freedom, good advice, put you in the right path, help you achieve the vision which you have for the company so pick and choose the right investor for yourself.

So by now we all understand the importance of a term sheet because it is the first document you sign with the investor. Although the term sheet itself is a small document, it lays out all the terms and conditions of your agreement with a particular investor. So as an entrepreneur going through these terms and having a good understanding is going to be very important to make sure that you are taking the best decision for your venture.

So I will take a sample term sheet. This is a term sheet of an investors called Tetrus partners that have funded a company called GoRooms and in this typically what we have is, we list down who are the founders of the company, who are the existing investors are if any if you have already raised a round of funding, what's the valuation, s, how much is the amount of money being put in and then what's the capital structure that the company will have both pre money and post money.

So I think investment amount is sort of what the amount is at each stage and what the range of general amount that people raise is. I think investment amount is basically how much money you are planning to raise in this particular round of funding so let's say you are doing a series A round of funding of 3 million and it could be that you know what as this round of funding I am going to raise 3 million dollars but out of this 2 and half million will be given by venture investor and maybe I will leave aside 500 thousand dollars for other sort of angels or seed funds to participate alongside.

So typically that's what we define as investment amount. I think a lot of these terms tend to confuse people a lot, what is pre money valuation, what is post money valuation, the best way to think about pre money valuation is what the investor is valuing your business today before the funding has gone through.

So let's take the example again, I am raising a 3 million series A round, if the investor were to come in and say based on what you have done so far, the team you have put together, the market, the product that you have built, the market opportunity in front of you, I am ascribing a total value to your business of 7 million dollars. So 7 million dollars becomes your pre money valuation, 3 million dollars more of funding comes in, that come on to your balance sheet which essentially says that your post money valuation so post this round of funding the valuation becomes 7+3 which is 10 million dollars.

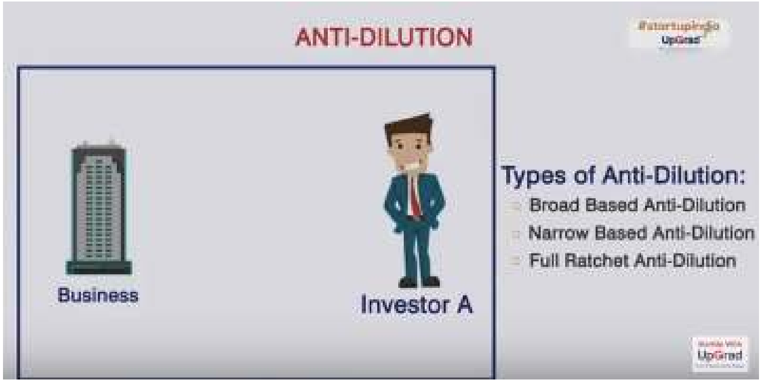
So I think the way to think about dilution in this case is 3 million dollars investment amount, 7 million dollars pre money, 10 million dollars post money, so the new investors coming in will basically own 30% of your overall company which means that if you dilute 30% of your company in this case.

So I think conditions precedent is a term in standard term sheet and what that condition precedent basically means is I have done my diligence, so I think conditions precedent is a term in standard term sheet and what that condition precedent basically means is I have done my diligence, I am signing the sort of shareholder's agreement and the share subscription agreement and the funding will be completed subject to certain conditions that have been met by the founding team or by the company Some examples of condition precedent are basically it could be anything that will require for example any time new funding round comes in you will typically you know you will change your memorandum of association, your articles of incorporations, it could say that these documents need to be edited, it could be completion of financial, legal and tax diligence, it could be obtaining specific approvals if at all such approvals are required from any sort of you know regulating authority etc.

So anti-dilution, I think this is the clause which the math is complex but let's try and just conceptually understand what it means. Let's assume that there is an example where an example that I gave, somebody has valued your company at a 7 million dollar pre money valuation, 10 million dollar post money valuation, what this says is if in the next round of funding your issuing shares below the price at which you issued shares to me, let's assume the price per share was 1000 rupees.

Now as an investor I expect that between my round of funding and next round of funding there is a growth in the business, there is progress in the business and the next investor coming in will value my shares at may be 2x, 3x whatever multiple may be. But it's going to be more than 1000 rupees.

In the scenario where for whatever reason that the business has not progressed or the business has not been able to hit the milestone that it said it would hit and or the market environment has changed and a new investor coming in is actually valuing the business at a price which is lower than the price at which I subscribe to the shares, it should protect me as an investor and say you know what you issued shares to me at 1000 rupees per share, the new investor coming in is buying shares at 800 per share, I need to be compensated because I essentially came in a lot more early, I took a lot more risk but the investor coming in is getting shares at a cheaper price than me.



So I think there are 2-3 formulae on which sort of additional shares that need to be given to me to compensate me for this anti-dilution is I think 3 different ways. One is a straight you know

- Broad Based Anti-Dilution, There Is
- Narrow Based Anti-Dilution
- Full Ratchet

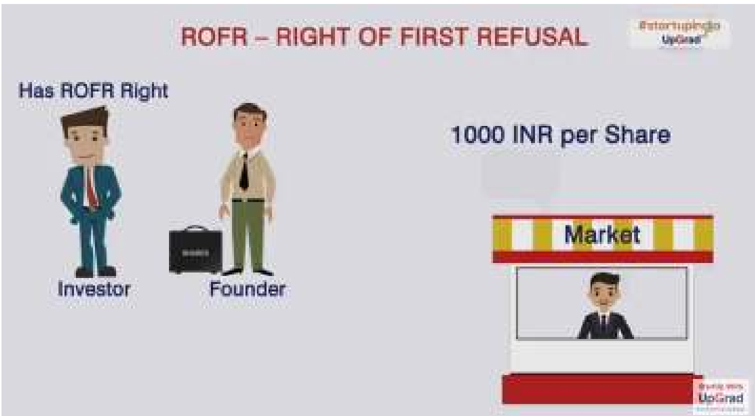
I think the math is something that you can look up online, there are sort of various sites which give these examples but conceptually this is what it means.

So I think affirmative rights also called AVIs or Affirmative Vote items or also called as reserved matters in some documents essentially what it says is here are the items where an investor approval, explicit investor approval will be required for the company to take that particular action.

Let's take some examples, It could be any liquidity event so if you decide to go ahead and issue extra shares in the company, if you decide to go ahead and sell the company to some other acquirer, if you decide to you know sometimes even hire key management personnel where the key personnel is drawing more than 50 lakhs, it could be a AVI item or affirmative vote item. It could be amending the rights and privileges of my shares .It could be taking on any debt greater than x amount; it could be you know venturing into new line of business so any of these things that materially change the company or change the rights and privileges of investor shares are typically kept as affirmative vote items.

I think the thing as a founder something that you should look for is obviously what is the bare minimum items that I should be giving as affirmative vote items to my investors that gives them comfort on their economic, financial and governance right, and at the same time doesn't limit my operational freedom.

So let's take an example where if there is any AVI which says that hiring of any employee above 10 lakhs. Now you need to think back and say in the nature of my business how many such employees will be hiring every year and you think if it's a large number you need to ask yourself do I want to take on this additional burden of writing to all my investors and seeking explicit approval for every person I hire. So I think that's something that you should think about if your investor says any employee more than a crore, that's fair because the reality is you won't be having too many people in that bracket so I think it's balancing out the investor's interest versus something that will give you operational day to day freedom to operate.

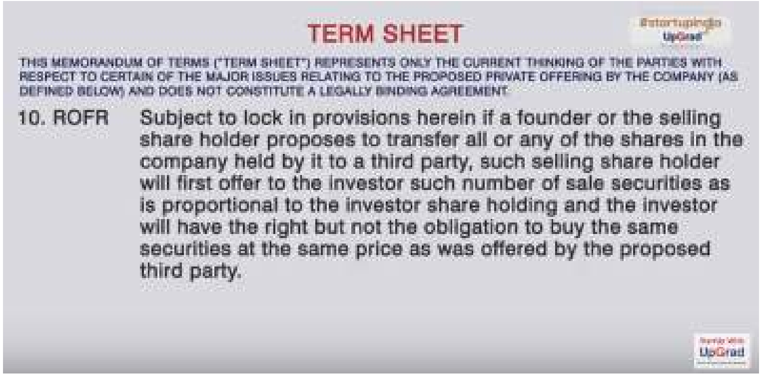


So I think ROFR and ROFO are two terms and you should understand the nuance difference between the two. So ROFR is typically the Right of first refusal which basically means that as the term says is that I as an investor have the right of refusing a particular, let's take an example, let's say you as a founder are looking for some liquidity during the sort of company building phase and say you know what I want to sell some x% of my shares, I as an investor if I have a ROFOR right, what it will say is that before you can sell your shares to any other party I will have the right to first refusal.

So if you have gone to the market, you got an offer and somebody is willing to offer you say 1000 rupees a share, it is your obligation and my right to first buy those shares at the same price and if I exercise my ROFOR right then it's your obligation to give those shares to me before you give them to anyone else.

ROFO is slightly different, ROFO is right of first offer which basically means that let's assume that I as an investor have a ROFO right on you, basically means that in that case you will not need to go to market and get a firm offer. You will straight first come to me and say hey Tarun, hey investor x I am looking to now sell 100 shares in my company, you have a right of first offer, so what is the offer you will make to me?

And let's assume that I make an offer of x to you what that basically says is either you take my offer or you are free to go and take an offer in the market if it is better than x and sell them, you don't need to come back to me . I think forget the technicalities in your term sheet you will have both ROFOR and ROFO explained in the sample term sheet that you have been given but understanding conceptually what it means is in one case an investor, the obligation on you as a founder is first to go out and get an offer, if you get the offer, I have a right to then or I have the right but not the obligation to match that offer. But if you right of first offer or ROFO essentially you come first to me. Obviously a right of first refusal is better because I know exactly at what terms you are being given an offer in the market and I can then accordingly decide whether that price makes sense to me or not.



So I think the right of first refusal if I just take the term sheet that you have been given, I think the way it typically read in the legal document and I have already explained conceptually what it means is subject to lock in provision herein if a founder or the selling shareholder proposes to transfer all or any of the shares in the company held by it which are the sale securities to a third party, such selling shareholder which is generally the founder or one of the angel holders will first offer to the investor such number of sale securities as is proportional to the investor shareholding and the investor will have the right but not the obligation to buy the same securities at the same price as was offered by the proposed third party.

This sounds obviously very complicated but conceptually as I have explained to you that it basically saying is at the same price investor has the first right to decide whether to buy the shares or not.

Components of a Term Sheet (ii)

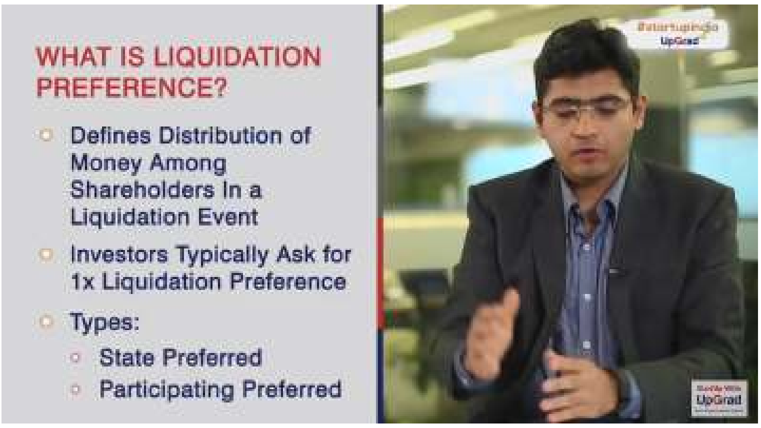
So right now we are in the middle of understanding the various components of a term sheet. We've already looked at things like conditions precedent, anti-dilution, right of first refusal and right of first offer. And I am sure, like me you've got a lot of clarity on what a term sheet looks like and what it means, but I think it's going to be very important to understand the rest of the critical components when it comes to a term sheet.

I think tag along again fairly simplistic, let's understand the concept first and then we will come to the specific things. Let's assume that you know you as a founder again you give me a right of first refusal, I refuse to you know buy those shares for whatever reason, sometimes investors due to liquidity constraint, it may be because my conviction in the business is not as strong as it used to be earlier for whatever reason, what tag along now basically says is that if you are selling a part of shares I as an investor have a right to tag along in that share.

So let's assume you hold a total of 1000 shares in the company and you are now looking to sell 100 shares to somebody else, what that basically says is if you are selling 10% of your shareholding to somebody else, I have the right to tag along in that and sell 10% of my shareholding and generally it is done in that sort of pro rata rights, so if you are selling 10% of your shares, I have the rights to sell 10% of my shares as part of that transaction and most investors will also have a clause where they say that if you are selling more than 50% of the shares that are allocated to you, I have the right to sell all my shares as part of that transaction because as investor what do you do, essentially I am betting on you, you are the founder, you are the entrepreneur for whatever reason if you are selling your shares in the company, I have no business to remain in the company after that because the bet that I have taken is on the founding team.

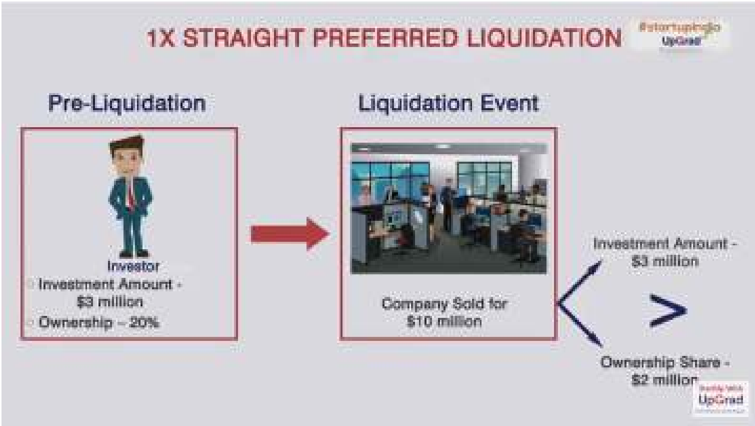
So I think drag is generally one of the exit rights, it's a right that investors sort of always will ask for, what a drag essentially mean, again don't look at the technical language and the legal, conceptually what drag means is that if I, let's assume that I have reached the end of my investment cycle, I need to exit the company, I need to sell my share to one of the party. Let's assume that the other party says that I want to acquire only 51% of the company otherwise I am not interested or some x number of ownership in the company otherwise they are not interested to buy. Now, what if I don't have that much ownership so let's assume that I as an investor hold 30% of the company and the buyer are interested only if they acquire at least 51% shares of the company. What this sells is I will sell 30% of my entire stake to the proposed buyer but me as an investor also have the right to get additional 21% such that the transaction is completed from other shareholders including the founding team, the management team, angel investors as the case may be.

Okay I think if you look at term sheet, these terms drag rights, tag rights, right of first refusal, and right of first offer the reality is like any other legal document. It can sound extremely complicated but once you understand it conceptually you will be able to then understand whether the core meaning of the term is been understood by you and as long as that is fine and you have a lawyer whom you trust, they will make sure it has been drafted correctly but understanding commercially and conceptually what you are giving up is very important.



What liquidation preference essentially mean, just again very conceptually, when the company goes through liquidation event, whether it is a sale or whether it is part sale, whether it is IPO or any other liquidation event in the company, frankly you know winding down of the company or bankruptcy,
It essentially says that whatever money comes in the company as part of the sale, how it is going to be distributed amongst various shareholders.

Typically every investor and most investors including matrix and other sort of funds will typically ask you for 1X liquidation preference which basically means that, let's assume again taking the example we started with earlier, let's assume I have invested 3 million dollars in the company and the company is sold for 10 million dollars and I hold say 20% of the company. If the company is sold for 10 million what it says is I have the right and again these are various terms which we will get into later, which is you know state preferred, participating preferred there are different ways of thinking about this, what it basically says is if I have 1X straight preferred, in the example I gave you it means that either I will take 3 million dollars which is 1X of the amount that I had invested in you or I will take 20% of the proceeds.



Now in the example I am giving you if I have invested 3 million, I own 20%, company is being sold for just 10 million dollars, it is in my interest as an investor to first take out my capital which is 3 million dollars, it doesn't make sense for me to take 20% of the total proceeds, that's typically what a straight preferred means.

Now let's take the same example with the straight preferred where the company is no sold for 10 million dollars where the company is sold for 50 million dollars, in that case 20% of my proceeds in the company is basically 20% of 50 million dollars is 10 million dollars. Now obviously as an investor in that case I have put I 3 million dollars but I am entitled my ownership is actually worth 10 million dollars in the company. So I will take either 3 million dollars or 10 million dollars whichever is higher, obviously I will take 10 million dollars which will be better turn I have made on my investment, so that's the straight preferred which basically says either you will take the liquidation amount which is 1X of the investment amount generally speaking or you will take whatever your ownership entitles you in the example I gave you.

A participating preferred on the other hand says that first I will take out my investment amount which is 1X, you know if it's 1X liquidation preference, I will first take out my investment amount and then in the remaining portion I will participate in proportion of my ownership. So again taking same example, let's assume I had invested 3 million dollars for 20% in the company; company is now being sold for 10 million dollars. If I have a participating preferred, I will first take the 3 million dollars out of the remaining 7 million dollars I will then participate up to 20%. So I will get 20% of the remaining 7 million, so I will get additional 1.4 million dollar back. So as an investor I get 3+1.4 = 4.4 million dollar, the remaining 5.6 is kept by the remaining shareholders right.

In the case of a participating preferred, again in the same example let's assume that it was a 100 million dollar outcome, the same calculation will apply, I will basically take my 3 million dollars and out of the remaining 97 million dollars I will take a 20% share of whatever I am due.

So generally I think in terms of what is the norm today, I think most venture investors will prefer to take a straight preferred 1X liquidation preference.

I think reps and warranties are basically, it's a standard representation that typically the founders of the company makes to the investors because investors you know we are coming into the business new, we don't know on a day to day basis what has happened in the company, how the company has been run in the past so it's basically a representation that the founders of the company typically give to the investors saying the typical reps and warranties that you give to your investors are A there are no ongoing litigations in the company you know all the intellectual property and trademark in the company has been sort of filed in the company or it is owned by the company, it could be around statutory dues and you know clearances etc. have been taken, basically you know that things have been done in a kosher way till now and if there are any issues around that front I am then indemnifying you from that claims.

I think exclusivity is one of the key terms in the term sheet and what is basically, an investor will always ask for it because it gives them sufficient time to complete the diligence without being put under pressure saying that at the same time I am negotiating with other investor because it is very easy today once I have a particular term sheet in my hand from one investor, it is now easy for me to take that same term sheet and go and shop it around at three other investor saying investor X is willing to fund me such and such amount at such and such valuation, are you willing to also give me a better offer.

So typically it is something which you know is not done in good faith but it is nevertheless put in term sheet saying that you know what once you and I have had verbal handshake here is the funding amount, here is he valuation, here are the key terms and both of us have agreed to proceed towards sort of consummating this transaction, you as a founder will items and not talk to anybody else in the meantime until I complete my diligence and you know get into formal sort of funding transaction.

So my advice to you as a founder, let's assume you have gone and met a bunch of investors and one of the investors, couple of investors are interested in actually proceeding with the funding transaction, you got a term sheet in hand, I think it's important to not only look at the valuation and funding amount but look at the term sheet in its entirety because the reality is that you have a bunch of terms that you are signing up for, each of those terms are in many ways correlated with each other and the funding amount and valuation is one term of the overall term sheet, it is very important obviously but it is also important about, there could be somebody who is giving you great valuation but the rights are very highly controlled or very highly in the favour of the investor. There could be other something where the valuation is slightly less but it gives you as a founder a lot more control over the company.

So I think it is important to sort of look at all these rights and interplay between these rights together so that you take the right decision.

So I think there are examples for example you know somebody has given valuation x but has asked for liquidation 2X preference whereas somebody else could have given a valuation which I 10% lower but is asking a 1X liquidation preference. In some cases there could be very onerous sort of AVIs or reserved matter of format items whereas other investors may not be giving you such a rich valuation but gives you a lot more operational freedom to run the business.

So I think it is important for you as a founder to read the entire term sheet and digest the entire term sheet in its entirety so that you know exactly what you are signing out for.

Post Term Sheet Signing

So we've now we've understood the key clauses of a term sheet and understood their importance. We've also got some very good advice on how to draft the term sheet to make sure that you find the right balance between investment amounts, investor rights as compared to your operational freedom that you have as an entrepreneur. Once a term sheet is signed there are still a few things left that you have to do as an entrepreneur before the funding really comes in. So let us listen to Tarun Davda from Matrix Partners talk about what an entrepreneur needs to do before the funding really kicks in.

So I think once the term sheet is signed typically what happens is the investor gets into what is known as due diligence. Due diligence has multiple aspects; one is just what we call as business or commercial diligence.

In a business or commercial diligence what we essentially do is we ask you for a lot of data, it could be on past transaction data, data of your customers, data of your suppliers, it could be data there is bunch of you know items that the investors will typically ask you for so then they can start analyzing each of those in detail and understating the real state of the business. Some of this data could already be shared up front; some additional data investors will typically ask you.

So that's for them to understand the business that I am investing in is this the same business that was shown to me pre term sheet signing. So that's one aspect, the second aspect is legal diligence which is you know are the company's memorandum of association correct, are the you know various incorporation documents done correctly, are all the sort of legal requirements that are needed in terms of compliance have all those processes followed up to this state. And I think the third one is the financial diligence which is taking the look at may be last 2 years balance sheets, profit and loss statement, have the various regulatory filings been made, has the tax been paid on time.

So I think forensic diligence is not generally done in early stage tech, it's done more for later stage deals or sometimes in offline businesses where promoters tend to have a lot other sort of business interest so forensic diligence I would say is largely follow the money trail in the busies, make sure where is the money coming in, where is it going out, look at sort of various sort of financial nature of transaction. It is done largely for more mature businesses, it is done for businesses where the promoter of the business also has multiple other business interest so you know taking into account related party transactions these are the things that are typically covered in a forensic due diligence.

All of these things are important so that the investor knows what exact risks the investor is taking on by being a shareholder in this company and a lot of these items lead to a CP or a CS which is Condition precedent or a condition subsequent which says we have done a complete diligence, our lawyers have come in, our financial tax consultants have come in, they have taken complete and they have understood that okay here are the things that were done correctly and here are 3 or 4 items which were not done, 2 of these which you now need to complete prior to me funding you which is called as condition precedent and two of these I am okay if you do even after funding as long as it is done in say in the next 60 days so that is called condition subsequent.

So I think once the diligence is done which I said could last anywhere from 4 weeks to 8 weeks depending sort of on the speed of transaction typically the investor will then hand you a formal share holder agreement and a share subscription agreement which basically lays out in legal language the same things that were agreed upon at the term sheet stage. So in your term sheet you know the drag along clause or the right of first refusal clause may be a few lines, in the actual share holder agreement it will be detailed out in very legal language with you know key definitions with you know various scenarios and how those scenarios would play out. It's basically explained in a lot more legally enforceable language.

So both these documents are typically given to you, you should have a lawyer on your side that will help you negotiate and appreciate these terms because slight change in language can change the meaning of these terms so you should be careful, you should have a lawyer on your side who is sort of negotiates similar documents in the past who can guide you and make sure that you understand interpretation of each of these things.

I think after SHA and SSA has been signed typically we head into a process which is called closing which is you know there is a series of more documents which need to be signed. It means amending your board resolutions, amending your incorporation documents, holding board meetings and passing sort of board meeting resolutions. Once all of those are done and when the money is coming in, typically that is called as closing process. It's basically just a bunch of paper work to make sure that all the approvals have been sought, all the right documents have been signed, all the existing shareholders are recording that the funding has come in, stuff like that, share certificate has been issued back to the investor etc.

So I think we covered a lot in this session on term sheet. Like I said you should start the overall process of funding 6 months prior to when you expect the money to hit the bank because the reality is it will take you at least 3-4 months to sort of meet multiple investors, get them excited about your business, discuss your business plans, get them comfortable, get the term sheet, give the investor at least 4-8 weeks to complete and get to the point where the money is coming into the account. So plan for this correctly, there is a bunch that we have covered in this session but hopefully it will be helpful for you as you start your fund raising process.

Summary – Term Sheet and Post-Term Sheet

So in this session we looked at the key components of a term sheet and understood the importance of each of these. We looked at a lot of key components including Investment Amount and Valuation. Then we looked at conditions precedent which defines the conditions subject to which funding gest completed.

Then we looked at anti-dilution which essentially protects the investors in case the company valuation decreases. Then we saw affirmative rights which essentially company rights are given to investors. Then we also looked at terms like right of first refusal, right of first offer and understood the critical difference between the two. Then we saw terms like Tag Along and its converse Drag Along. Then we looked at Liquidity Preference, Reps and Warranties and we finally discussed Exclusivity. After looking at the term sheet we also got an idea of the process that happens after the term sheet has been signed.

Once the term sheet is signed the investors do various kinds due diligence

- Business
- Financial
- Legal
- Forensic

And this process can take anywhere between 4- 8 weeks. After the due diligences are completed both the founders and the investors sign a Shareholders agreement and a share subscription agreement after which the entire process is completed and the funds are transferred. Hope you enjoyed the program as much as I did and it was great interacting with you for the last 15 weeks. Good luck with your entrepreneurial journey and I look forward to seeing you soon