Entrepreneurial Finance

The Art and Science of Growing Ventures

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CHAPTER 9

THE TERM SHEET AND NEGOTIATING WITH INVESTORS

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Equity investment involves a partnership and is temporary, since from the outset the investor and entrepreneur know it will eventually come to an end. Although the term sheet is the key document to be negotiated, the parties will first define and exchange various pieces of information and reach an agreement about both day-to-day and medium to long-term behaviours. Second, they must commit to working together and to complete transparency when managing any agency problems that arise. The end goal of the investor and the shareholders of the company is always the same: the creation of value. This issue divides successful operations from failures, allowing the investor and the startup to achieve the expected returns. Although they have a common goal, they may have differing views on many aspects of the business. Conflict typically arises, for example, over the duration of investor involvement, the strategies used to increase company value, financial and industrial alliances and new opportunities that modify the pre-investment situation. Both the investor and the entrepreneur will try to solve all potential disagreements before the decision is taken to invest and to partner together; however, it is impossible to forecast the future and legislate for every eventuality. Conflicts may also arise because the investor has his own portfolio to manage with constraints arising from the IRR objective, the residual maturity, the regulatory capital and covenants settled between the fund's originators. On the other side, the venture-backed company and the founders will have their own strategic, financial and personal goals that may differ from those of the investor.

VIEW FROM THE MEDIA

FINANCIAL TIMES FT

When VCs get two bites of the apple

APRIL 6, 2017 BY KADHIM SHUBBER

There are a million ways to do over the investors in your company, but the simplest is to sell the business at a valuation lower than the one they invested at.

Take £10 m from someone at an £100 m valuation giving up just 10 per cent of your venture spend the money on lavish hotels, flights and anything else you can claim as a business expense, and then sell the company to anyone who'll buy it for . . . let's say £10 m again.

You walk away with a bunch of fun memories plus another £9 m in your pocket from the sale. Your investor, on the other hand, gets back just £1 m 10 per cent of the new, much lower valuation. Most of their money has disappeared.

This is the scenario venture capitalists describe when they explain why 'preferred' share structures are justified. They arrange their investments in such a way to give them first dibs on a certain amount of money typically the same sum they invested when a company is sold.

If everything goes well and a business has a big sale or stock market float, then the structuring becomes all but irrelevant. However, in tougher times, as we discussed a couple of weeks ago, these arrangements can be a disincentive for entrepreneurs. (Why bust your gut if your investors are going to get most if not all of the proceeds of a sale?)

But this is finance and that means things inevitably get even more complicated. This time we're going to look at the way venture capitalists have structured their investments in two of the UK's rising fintech stars: Funding Circle and Transferwise.

The way preferred investments are commonly structured is as a "non-participating preferred" structure. This means the investors either get their money back in a sale, ahead of anyone else, or they get a share of the overall cash pile as if they were an ordinary shareholder.

That's how Transferwise's shareholdings seem to be structured . . .

Relatively straightforward.

Funding Circle, on the other hand, seems to have a more complicated setup called a 'participating preferred' structure. This means the investors get their money back in a sale, ahead of anyone else, and they get a share of the cash that's left over. They basically get to have their cake and eat it too.

. . . While 'non-participating' structures are common in venture investing, several London-based VCs told us "participating" structures are relatively rare.

When do they occur? Fred Wilson from Union Square Ventures, which is a long-time investor in Funding Circle, wrote about two scenarios back in 2010:

'First, it is a great way to bridge a valuation gap with an entrepreneur. Let's say we feel the business is worth $10m but the entrepreneur feels it is worth $20m. We could bridge that valuation gap by agreeing to pay $20m with a participating preferred. If the Company is a big winner, then it won't matter if we paid $10m or $20m. But if the Company is sold for a smaller number, say $50m, then having the participating feature gives us a return that is closer to what it would have been at our target valuation of $10mm.

The other place a participating feature is useful is when the entrepreneur might want to sell the company relatively soon after your investment. In that case, there is a risk that not much value will be created between your investment and an exit. A participating preferred works well in that situation as well.'

LEARNING OBJECTIVES

After reading this chapter, you will be able to:

- Understand the goal and the main characteristics of the term sheet, the document which is most commonly used to support the negotiation phase.
- Recognize the most important points contained in the term sheet and understand which aspects relate to the entire negotiation phase and fall outside the scope of the term sheet.
- Perform a detailed analysis of the contents of the term sheet.
- Understand the role of covenants and the appropriate usage of them, according to the specific profile of each deal.
- Coordinate all relevant aspects of the investment (i.e. business planning, company valuation, due diligence, etc.) with the term sheet and the negotiation process.

Where Are We Going Next?

This chapter will briefly define what a term sheet is as well as other key legal documents. Then, it will review the main issues surrounding the negotiation which will form the basis of the document lawyers will use to write the contract of investment. Finally, the chapter discusses the topic of rights and reviews major covenants and mechanisms used to regulate the relationship between the investors and the founders of the venture-backed company.

9.1 Definition of Term Sheet and Other Key Documents

A **term sheet** is a document that outlines key financial aspects, such as number and category of shares to be bought and their price, as well as a long list of terms for a proposed investment. The term sheet can be known also as the 'Letter of Intent' (LoI), 'Memorandum of Understanding' (MoU) or 'Agreement in Principle'. Investors use it to make a proposal to the entrepreneur and it is the basis for drafting the final investment documents. With the exception of certain clauses (commonly those dealing with confidentiality   i.e. company can't disclose terms or even existence of term sheet   exclusivity   i.e. company can't shop the deal, usually within 30 60 days   and sometimes the costs of performing a due diligence or similar expenses), the provisions of a term sheet are not usually legally binding. That means that even if you have received a term sheet from a famous venture capitalist, you should not start celebrating the round yet, because the round is not closed until the final document (of a very long list) is signed. The term sheet is bona fide, which means that the investor has the intention to invest in the company, and that the negotiation and the due diligence process that will follow is intended to finish in a satisfactory investment. But bear in mind that things can change in the weeks, sometimes months, that it will take from preparing the term sheet to closing!

The term sheet is at the core of the negotiation with investors, and although it is not binding, because it is subject to final documentation, due diligence and other closing conditions, such as legal opinion or audited accounts, practically speaking, it is very unusual for the actual deal to vary significantly from the term sheet itself. For this reason, in this chapter, and in the real world too, we consider the term sheet as equivalent to 'the contract' around which the entire negotiation process revolves.

Once the term sheet has been negotiated, using the exact legal taxonomy, the documents that need to be signed for an investment round are a 'Subscription Agreement' (also known as 'Sale and Purchase Agreement', or SPA) and a 'Shareholders' or Investors' Rights Agreement'. Frequently, these two documents are combined into a single 'Subscription and Shareholders' Agreement' or 'Investment Agreement and Articles of Association'. All the provisions, conditions and rights of the term sheet will be included in these documents. You will find examples in Appendix 3 and Appendix 4.

The **Subscription Agreement** will usually contain details of the investment round, including number and class of shares subscribed, payment terms and representations and warranties about the current condition of the company. These representations and warranties (investors refer to them as "Reps & Warrants") will be qualified by a disclosure letter and supporting documents that specifically set out any issues that the founders believe the investors should know prior to the completion of the investment.

A **Shareholders' Rights Agreement** will usually contain investor rights and protections. These include economic rights, political rights, such as board representation, and non-compete restrictions. The provisions or terms in this shareholder agreement will, hopefully, be used as the basis for subsequent funding rounds. Therefore, it is important for the entrepreneurial team to negotiate well in the first instance and to have good legal advisors.

Some of the protective provisions in the Shareholders' Agreement may instead be contained (or indeed repeated) in the **Articles of Association**. The decision to include terms in one or both of these documents may be jurisdiction-specific, based primarily on company law restrictions (some Continental European jurisdictions limit the rights that can be attached to clauses in the Articles of Association), enforceability concerns (investor protections can be difficult to enforce in some Continental European jurisdictions) and confidentiality concerns (Articles of

Association typically must be filed as a public document with a relevant company registry while the other investment documents can often be kept confidential).

However, the entrepreneurs will first of all deal with the term sheet, and then, once everything has been agreed upon, the lawyers will come in to draft the final documents (the name used for these documents will vary according to the country in which you are based). The more detailed the term sheet, hopefully, the fewer the issues which will need to be agreed on during the drafting of the contract. The process can be complex, and it is recommended that, in order to minimize both timeframe and costs, you work with lawyers who are familiar with venture capital transactions. It may be that one of your best friends is a very good lawyer. But the fact that she is the top specialist in divorce law or labour law will not be very helpful when it comes to dealing with raising capital and negotiating with early-stage investors.

One venture capital firm usually leads a venture capital investment round. The venture capitalist leading the round is known as the 'lead investor'. He will put together a syndicate of investors (before or after the Term Sheet is agreed) and then he will coordinate the syndicate until the round is completed. The syndicate will usually comprise some or all of the existing investors and some new ones. The lead investor is the one investing more money in that round. The new investors can be invited to the syndicate by the lead venture capitalist or brought by the entrepreneurs.

9.2 The Main Challenges in the Negotiation with Investors

The term sheet documents the agreements made between entrepreneur and investor. The negotiation with investors aims to define the commitment of the investor to the venture. It impacts and sustains value creation and allocates duties and rights between the investor and venture. The term sheet (which will be transformed into a contract as mentioned) facilitates management and control of the process and allows both parties to identify the proper balance of risk and return. Governance of the venture plays a key role and will be analysed separately in Chapter 11.

The typical challenges in completing the term sheet pertain to balancing the control between investor and entrepreneur and their role in the allocation and monitoring of investments. More particularly, three types of issues can be distinguished: (1) the type of shares, (2) the use of funds, and (3) the rules post-investment (i.e. monitoring and adding value).

9.2.1 Type of Shares

The key financial issue to be defined within the contractual package is the level of engagement. The first step involves choosing which categories of shares or share class to buy, with the aim of ensuring that the investment and management can be fully guaranteed. As there may be many rounds of financing, each round of shares is labelled with a different capital letter: series A will be the first one (i.e. 'A' shares), series B will follow, and so on. Series B and subsequent series will usually piggy-back off the terms formulated for the previous rounds: entrepreneurs should be aware that they will have to live with the investors involved in earlier rounds. As a rule, after Series A, terms can only deteriorate because of further dilution and control issues. At every round, there is a complex balancing act in order to preserve the rights of the previous rounds' investors and to create incentives to attract new investors. To that end, the investor has the option to choose from several different types of shares, all having their own associated rights and duties:

- **Common shares** are securities representing equity ownership in a corporation, providing voting rights, and entitling the holder to share in the company's success via dividends or capital gain. The holders receive one vote per share which can be used to elect the company's Board of Directors and to decide on company matters such as stock splits and company objectives.
- **Preferred stock** does not usually include voting rights, or provides at least limited rights in extraordinary matters. This is compensated for by offering priority over common stock in the payment of dividends and upon liquidation. Their dividend is paid out prior to any other dividends. Preferred stock may be converted into common stock.
- **Convertible preferred stock** is a preferred stock that can be also converted, if the shareholders wish, into common stock. This status gives the investors the option to choose whether to take their returns on liquidation event or through the underlying common equity position.
- **Participating convertible preferred stock** is a convertible preferred stock that has got an additional characteristic, which is that in the event of a sale or liquidation event the investor has the right to receive the face value and the equity participation as if the stock were converted.
- **Shares with embedded option** provide rights entitling the holder to buy company stocks issued at a predefined price due to an attached option. It is not traded by itself, and it affects the value of the share of which it is a part.
- **Tracking stock** is a security issued by a parent company related to the results of one of its subsidiaries or lines of business. Financial results of the subsidiary or line of business are attributed to the tracking stock. Often, the reason for issuing this type of stock is to separate the high-growth division from a larger parent company. The parent company and its shareholders remain in control of the subsidiary or unit's operations.

There is also convertible debt or notes (See Chapter 8). However, strictly speaking, they don't represent 'shares', at least not in the traditional sense. Convertible notes are popular for very early venture capital/seed investment and are offered together with shares. A convertible credit note represents a credit the investor holds, which can be converted into common stock at a certain date (or in a certain time window). The conversion rate is agreed at the outset (1:1, 1:1,5, 1:2, etc.) and may be subject to certain conditions. The rationale for using these convertible notes is to protect the investor until the conversion date. The holder of the convertibles can choose to remain a creditor or become a shareholder. The choice made is determined by the development of the venture. In the event that the venture does not perform well, it might be preferable to be a creditor, whereas, if the venture surpasses all expectations, converting the debt into shares (at a favourable price, as dictated by the conversion rate) is more lucrative.

One important and more general caveat: having a preference (i.e. a preference for the venture capital investor) between different types of shares is normal practice, but it is best to focus on trying both to minimize participation and accrue dividends. Moreover, it's important to understand how the various preferences interact so that everyone's incentives are aligned. It can get very complicated when multiple rounds are stacked up. In some cases, there may be flat spots or even drastic jumps of multiple that create divergent incentives. The early rounds set a precedent for later rounds, so that early investors that are too greedy on terms may live to regret it. Sometimes a preference can be used to bridge a valuation gap, but again, worry about the precedent in that case.

9.2.2 Use of Funds

Another key challenge during the engagement stage concerns the paying policy (use of funds), which involves the technique of issuing shares and the relationship of management within company corporate governance.

To ensure an effective and satisfactory paying policy, three basic questions need to be answered:

a. What is the source of the money? The investment can be obtained through new shares issued by the company or old shares sold to the investor by the entrepreneur/owner.
b. What are the entrepreneur's reasons for issuing the shares? The two main reasons are: the entrepreneur simply wants to generate cash for him/herself or because the entrepreneur feels he needs financial or strategic support to sustain the activity and growth of the venture.
c. What does the relationship with the other/existing shareholders look like? The venture capitalist could invest in the company and keep total control of the risk capital, or retain all or part of the existing shareholders and negotiate the exit of those fired.

Answers to these three questions provide an insight into why the funding is needed and how it will be allocated. Whatever the occasion/choices made, investors will need to be triggered to invest.

9.2.3 Post Investment Monitoring

The role of the term sheet and the aim of the negotiation, once the deal is closed, is also to facilitate the managing and monitoring of investors (as previously discussed in Chapter 6), to ensure the creation of value and the control of any opportunistic behaviour by the venture.

There are two completely different areas of focus during the post-investment phase for creating and protecting value: how to create and measure value, and how to live together as a team. The first one involves the setting of strict contractual rules, where the goal is to enhance the liquidity event and the performance of the business. The second aim is to agree upon the package of behaviours, mechanisms and tools the venture capital investors will offer and deliver to the venture-backed company, even if most are incapable of being expressed in contractual terms but represent per se the core values of equity investment. For these reasons, they could be called ‘soft factors’.

These obligations are qualified as contractual covenants and help both the entrepreneur/founder and the venture capital investor to:

- Set standards   once goals have been identified they must be translated into standards to become effective.
- Use as motivators for the venture-backed companies   the main tools to motivate employees are money, status and recognition.

9.3 The Term Sheet in Action: Reducing Risks

Venture capitalists and business angels provide money and value added to the portfolio companies. This is why it is known as ‘smart capital’. However, the participation and involvement of the equity investor in the venture-backed company requires rules. The goal is to reduce conflicts and mitigate agency problems between the investor and the entrepreneurs. A detailed discussion of agency problems is included in Chapter 6. The investment period is defined as a ‘temporary marriage’ and is a time when both the investor and the founders have very specific risks to avoid.

New ventures are founded in many different countries and industries. They have different goals and are at different stages when looking to raise new funds. As a result, each deal is different in terms of the type of investor, number of participants, deal structure and amount of funds needed. Consequently, the number and the nature of risks that could arise makes it impossible to forecast and cater for all the possible conflicts. This is the main role of the term sheet. During the term sheet negotiation process, the contractual covenants (i.e. the different points negotiated) will be used to help reduce and mitigate all anticipated risks. Each party will be worried about different risks. Let’s look at it from both perspectives.

9.3.1 The Investor's Perspective

The investor will become a partner in the company. However, they will not be present during the day-to-day operations of the business to ensure that things are done in the best interests of the shareholders. Therefore, the investor is interested in avoiding the following risks:

- Poor operational, industrial or marketing decisions by management that affect the firm's performance and thus reduce its value in the medium to long term.
- Lack of commitment from the entrepreneurial team and key personnel that might reduce the effectiveness of the business plan.
- Divergence of opinion on the right timing for creating value. Founders might be aiming to create long-term value, but remember that venture capitalists need to exit in the medium term to cash out and return the money to their investors. Certain decisions can directly impact the IRR for the investors.
- Entrance of new shareholders that can generate conflicts between parties.

9.3.2 The Entrepreneurs' Perspective

The founders have created the startup with a vision and a mission in mind. Some of them may plan to stay in the company for the long run. Others may be even thinking about passing it on to the next generation. Most of them see it as their 'baby'. For all these reasons, the entrepreneurs are interested in mitigating the following risks:

- Lack of involvement and commitment from the investor that reduces the available financial resources or the advantages connected to the investor's network or expertise and knowledge.
- New shareholders entering into the equity which may impact on the balance between the entrepreneur and the investor (for example, by leaving the entrepreneurs as minority shareholders). Additionally, depending on the profile of the new investor, this may affect the company's strategy.
- The investor exiting at the wrong time, which may impact the overall result of the investment. The negative effect can involve fewer financial resources than expected (if the venture capitalist exits too soon) or excessive meddling from the financial partner, if the venture capitalist adopts a late exit strategy when the entrepreneurs want to sell.
- Exiting surprises interrupting the investment cycle and negating the realization of value for management and the entrepreneur.

VOICE OF THE EXPERT: Laura Urquizu (Spain)

With over twenty years of experience, Laura Urquizu is the CEO of Red Points, a startup dedicated to brand protection, copyright protection, and preventing the distribution of illegal content online. Laura is driving the worldwide adoption of Red Points technology and is currently expanding company sales throughout the globe with significant market penetration throughout Europe and the United States. She has previously held the role of Advisor of the Board of Directors and Corporate Development at Lokku and Board Director and Advisor at Openshopen. Laura has acted as a Member of the Board of Directors for numerous technology companies throughout Europe, including: Abiquo, Spamina, Just in Mind, Deneb, D2D, Biko2, Adecq (Best TV) and DAD.

Source of funding what primary/secondary source of funding did you pursue and did you consider alternatives?

We raised two financing rounds, with private capital – in both cases we considered carefully the company's development stage in order to select the investors that would fit best. For the first round, in seed stage, we raised from business angels, while for the Round A we looked for an International Venture Capital firm that could help us expand internationally

Term sheet negotiations to what extend did you allow the investor to negotiate the term sheet?

It's very important to align the interests of the investors with the ones of the company sponsors so that everybody feels comfortable in the partnership. Once the investment deal is closed, the investors become new shareholders and play a very important role in the company's growth, so interest alignment is crucial.

9.4 The Term Sheet in Action: Key Terms

Mutual trust and patience is the best way to manage risks. However, when things do not go as planned and start looking ugly, trust and patience disappear very fast. For this reason, venture capitalists, with lots of experience in the topic, use specific contractual rules that will help to sustain mutual trust and patience in the bad times. These rules (the 'covenants', 'terms' or 'clauses') are usually designed to fit the deal. However, many of them are pretty standard, and are used worldwide by financial investors and entrepreneurs.

Covenants fall into two broad categories: positive and negative. **Positive covenants** are the list of things the entrepreneurial team and the company agree to do, including producing audited reports, holding regular board meetings and paying taxes on time. **Negative covenants**, usually included in the preferred equity agreement, serve to limit detrimental behaviour by the entrepreneur. Thereby, certain actions are expressly forbidden or require the approval of the investors (known as 'veto' power). Covenants may also include **ratchets** which are contractual agreements that provide the option to change duties or rights should specific conditions occur. For example, if the entrepreneurs meet the business plan, they will get additional shares.

Each covenant is de facto a stand-alone agreement, with pros and cons that clearly identify the rationale for its usage. However, the main concern during the negotiation process is not to select the right covenant, but to identify a group of covenants that will in conjunction mitigate the risk of conflicts while maximizing shareholder value (including ensuring a timely liquidity event for the investors). The following section describes the most commonly used covenants. They can be classified into four groups according to the rights that they entitle: economic, political, team commitment and other rights.

9.4.1 Economic Rights

The owner of preferred shares is entitled to some specific economic rights which, in the case of venture capital and private equity deals, are related to the liquidity event (i.e. the exit of the investor). The most commonly used economic rights are: (a) liquidation preference; (b) anti-dilution provision; (c) transfer of shares; and (d) call and put options.

Liquidation Preference

This is a provision that grants the preferred stock preference over common stock with respect to any liquidity event, dividends or payments in the event of the liquidation of the firm. In venture capital, the most common application is not related, of course, to dividends (as venture capital is mostly based on capital gains) but to the moment the company is sold (the liquidity event). The intention is to lead to an exit price for the venture capital investor which is in line with its IRR expectations. The way it works is that preferred stock (that held by the venture capitalist) has the right to get its money back before the common stock gets anything (i. e. the 'preference'.). Sometimes, the investor gets his money back more than once. To calculate the amount, 'multiples' are used (1×, 2×, 3× the investment amount) and sometimes accrued, but not paid; dividends are also included. This is essentially like adding an interest rate component to the preference (range of between 4 and 9 per cent).

After the investor gets their money back, the remaining amount of money (if any) will be distributed between the entrepreneur and the investor. There are three main options (ranked in increasing order of severity): (1) Non-Participating Preferred, (2) Capped Participating Preferred, and (3) Uncapped Participating Preferred. Let's see how it works (and remember this applies for any 'liquidity' event, not only for the liquidation of the company):

- Non-Participating: First pay the original purchase price on each share of Series A Preferred (i.e. the total amount invested by the venture capitalist). Thereafter, the balance of any proceeds shall be distributed pro rata to holders of common stock. In this case, the venture capitalist will only get his money without interest (maybe more than once). The remaining proceeds will be distributed between the entrepreneurs, friends and family and business angels.

- Participating with cap: First pay the original purchase price of each share of Series A Preferred (total amount invested). Thereafter, Series A Preferred joins with common stock on an as-converted basis until the holders of Series A Preferred receive an aggregate of x times the original purchase price. This is known as double dipping (with a cap).
- Participating without cap: First pay the original purchase price of each share of Series A Preferred. Thereafter, the Series A Preferred joins with the common stock pro-rata. No limit in this case, so double dipping (without a cap).

Calculating Final Outcome with Different Types of Liquidation Preference

Let's assume a €5m Series A investment at a €20 pre-money valuation (resulting in the Series A investors owning 20 per cent of the company). The company ends up being sold for €40 without any additional shares being issued after the Series A investment.

A '1× Non-Participating Preferred' means Series A get the greater part of their €5m preference, or what they would receive if they converted to common stock (i.e. 20 per cent of €40m, or €8m). Result: €8m goes to Series A (20%); €32m goes to common stock (80%)

A '1× Participating Preferred with a 2× Cap' means Series A get their €5m preference plus 20 per cent of the remaining €35m up to a total 2× cap (€10m). Result: €10m goes to Series A (25%); €30m goes to common stock (75%)

A '1× Participating Preferred without a cap' means Series A get their €5m preference (the 'preferred') plus 20 per cent of the remaining €35m, or €7m (the 'participating'). Result: €12m goes to Series A (30%); €28m goes to common stock (70%).

Anti-dilution Provision

In a preferred stock agreement, the anti-dilution provision is the mechanism that adjusts upwards the number of shares (or the percentage of the company) held by venture capital investors (holding of the preferred shares) if the firm subsequently undertakes financing at a lower valuation than the one at which the preferred investors purchased their shares. The rationale is to protect investors in a future 'down round'. This happens when new money is invested at a pre-money valuation (or price per share) that is lower than the previous round's post-money valuation. Best practice provides for two main types of provision: full ratchet and weighted average (broad-based and narrow-based). A full ratchet anti-dilution provision compensates investors in earlier rounds for a lower price in a subsequent round based on the difference between the price of each round, ensuring that the investors' ownership percentage remains the same as if it had occurred at the new lower price. It's important to note that even a small round of financing at a lower price could lead to an adjustment. Weighted average anti-dilution is a mechanism to compensate venture capital investors in earlier rounds for a lower price in a subsequent round based on the average price of each round weighted by the number of shares held.

The conversion price for investors is automatically adjusted downward if the company issues new shares (i.e. series B) below the share price that investors have originally paid (down round). The adjusted conversion price for investors will be set to the lowest conversion price of any later stock issue (full ratchet protection). Given:

PB = price paid by Series B investors
$CP2$ = adjusted conversion price for Series A investors
OPP = original purchase price for Series A investors
$n(\mathrm{A})$ = number of shares subscribed by Series A investors.

If:

$PB < OPP$.
Then $CP2 = PB$ and $n(\mathrm{A})$ is adjusted according to the following formula:
$n'(\mathrm{A}) = [OPP \times n(\mathrm{A})]/CP2$.

Where $n'(\mathrm{A})$ is the new number of shares held by Series A investors. The anti-dilution provision will not apply for any capital increase made in conjunction with employee participation programmes.

As a reference example, suppose that Series A investors pay €3 million for one million A shares at €3/share (OPP) and that founding shareholders hold two million shares (€1 per share). If the Company issues three million Series B shares at €1/share (PB) so that $PB<OPP$, then the adjusted conversion price ($CP2$) is set at PB = €1 and the number of shares held by Series A Investors ($n'(\mathrm{A})$) becomes 3,000,000/ €1 = 3 million shares. In this way, total shares outstanding after Series B financing are eight million, Series A investors hold 37.5% of the total shares like Series B investors, and founders retain a stake of 25%. Post-money value is €8 million and pre-money value is €5 million (€8 million €3 million).

Transfer of Shares

There are several terms that relate to the transfer of shares (buying or selling shares). The following are the most common:

- **Right of first refusal (ROFR):** If one shareholder wants to sell their stakes, this provision allows the venture capital investor to avoid including undesirable new shareholders in the company. The venture capitalist has the right to refuse the new shareholders' entrance, but he must acquire the stake of the outgoing shareholders under the same terms offered by the potential buyer.

- **Right of first offer (ROFO):** This is a contractual obligation of a shareholder (i.e. it applies to both the founder/entrepreneur and the venture capital investor) to a rights holder to negotiate the sale of the equity with the rights holder before offering the equity for sale to third parties. If the rights holder is not interested in purchasing the equity or cannot reach an agreement with the seller, the seller has no further obligation to the rights holder and may sell the equity. A right of first offer is closely related to a right of first refusal, but the former is considered to favour the seller, while the latter is considered to favour the prospective buyer. A right of first refusal gives the holder of the rights the capacity to match an offer that has been received by someone wishing to sell equity.
- **Tag along right**: An agreement to protect the minority shareholder in the startup (i.e. the venture capitalist or the business angel). If the majority shareholders (the founders) sell their stake, the investor has the right to join (pro rata) the deal, so he can sell his minority stake in the venture-backed company at the same terms and conditions to the same buyer.
- **Drag along right:** If the venture capitalist wants to sell his stake, this mechanism provides the right to ask (i.e. force) all other shareholders to sell their stake under the same terms and to the same buyer. This clause was introduced to ensure that venture capitalists can sell a minority stake and maximize the selling pricing by forcing the sale of the majority stake (or even 100 per cent of the company).[1] This allows the buyer to purchase the entire company in one go. It's probably the clause that favours the equity investor the most, because through this mechanism the equity investor whatever the size of their stake, even a minority one is able to sell one hundred per cent of the shares of a certain company, significantly enhancing the liquidity event. However, this clause is very unlikely to be agreed to by the entrepreneur who has to be prepared to lose his/her company and for this reason it occurs only in two very different circumstances: the sale of the company is an accepted outcome; the sale of the company is the consequence of the breaking of other covenants, such as the put option, when the entrepreneur doesn't have sufficient liquidity to buy back the shares.
- **Call and put options**: This mechanism represents the presence of a call option and a put option, which are embedded into the shares. More precisely, these are part of the financial agreement according to which the existing shareholders have the right to buy the stocks from the private equity investor ('callable') and the private equity investor has the right to sell the stocks to the existing shareholders ('putable'). In both cases, the option agreement can be executed with or without a specific date on which to exercise these options. These securities can be single or combined; that is, only call or put or both call and put together. In both cases, the strike price could be fixed, floating with

1 A minority stake, in general, means that you do not control the company. It is for this reason that a majority stake is worth more. This is referred as the 'control' premium.

a fix multiple, or floating with a fix multiple and with a price floor. The fact that the entrepreneur (or the existing shareholders more generally) has a call option indicates the preferred means of exit for the entrepreneur is to fire the equity investor. From the investor perspective, this mechanism enhances the liquidity event significantly and it helps to fix ex ante the IRR (when the strike price is fix) or the minimum value of the IRR (when the strike price is calculated on a fix multiple and a price floor). The presence of a put option is the most fully developed covenant for enhancing a liquidity event. However, as the put option is exposed to liquidity risk, it is very common for the equity investor to require a partial liquidity guarantee, having a pledge on securities inserted in an escrow account. In the event that the put option is exercised, the equity investor can use the pledge for the missing liquidity; should the entrepreneur be unable to pay, multiple scenarios could happen: a discount of the price of the buy-back; a renegotiation of the date of the exercise of the put option; the arranging of a bridging finance to generate the liquidity; a further renegotiation based on the concept of PIK (i.e. payment-in-kind), where the equity investor receives free shares of the venture-backed company and the lack of liquidity is compensated for by the chance to have a higher IRR in the future because of the larger amount of shares held; or, as an alternative to PIK, the use of a drag along right, giving the equity investor the option to sell 100 per cent of the company, which is much easier than to sell a percentage lower than the 100%.

9.4.2 Political Rights

Political rights are designed to provide control rights to the venture capitalist. She might be a minority investor, but 'de facto' has majority powers. The entrepreneurial team may believe they control the company, but the moment venture capital becomes a shareholder in a company, the rules of the game change. The most common rights are: veto rights; information rights; seats on the board of directors and voting rights. The venture capitalist will need to approve certain key matters, of which the following are the most relevant:

- **Asset sales covenants**: these are restrictions placed on selling assets above a certain value or assets representing a certain percentage of the firm's book value. This prevents the entrepreneur from increasing the risk profile of the company and changing the firm's activity from its intended focus, and also from making 'sweetheart' deals with friends.
- **Merger or sale covenants**: limitations preventing a merger or sale of the company without the approval of the investor. Transfer of control restrictions are important because venture capitalists invest in people and, if the management team decides to remove its human capital from the deal, venture capitalists would want to approve the terms of the transfer. Controlling transfers

may harm the position of the private equity investor if the terms are unfavourable to earlier investors.

- **Asset purchase covenant:** restrictions placed on the purchase of major assets above a certain size threshold that may be prohibited without the approval of the venture capitalist. These restrictions may be expressed in absolute terms of value or as a percentage of the book value of the firm. These covenants may help prevent unwanted changes in strategy or wasteful expenditure by the entrepreneur.
- **New securities restrictions:** these limit the issuance of senior securities without the approval of previous investors and prevent the transfer of value from current shareholders to new security holders. Approval for this must be obtained by the super majority consensus of the shareholders.

Information Rights

Information rights define the quantity and periodicity of financial and qualitative information to be provided to the investors. In early-stage deals, this might be monthly. When the company is a bit more mature, this can be changed to quarterly reporting information. Normally, the periodicity relates to the date of the meeting of the board of directors. The information that is requested is used to monitor and control the investment. See Chapter 10 for more detail on this topic.

Board of Directors

Corporate governance rules also provide a set of dispositions that dictate the structure and operation of the company's main functions. Usually the venture capitalist has a representation on the Board of Directors proportional to the dimension of the capital subscribed. Rules for the Board of Directors should grant veto power to the venture capitalist representatives on the most important matters. For the Board of Directors to function effectively, it is advisable to appoint at least one independent member who does not have any type of personal relationship, such as affinity or family relationship, with the other members of the board or with the shareholders, who does not participate, directly or indirectly, in the risk capital of the company, and who has no power to influence the autonomy of the other members, for example, by his own economic resources. The Board of Directors should meet at least quarterly, if not monthly. The quorum provided for should be higher for all topics relevant to the existence of the company's, for example, dividends and reserves distributions, changes to the articles of association, and for all extraordinary operations, such as a merger and acquisition or an initial public offering. The previously mentioned veto power should cover annual budget approval, the appointment and firing of the Chief Executive Officer (CEO) and Chief Operations Officer (COO), stock option plans approval, restructuring and turnaround plans, delegations of authority and remunerations of the directors, financing operations (debt issuing), capital expenditures operations and putting up collateral. To ensure on-going dialogue between management, the entrepreneur and the venture capitalist, the company should produce monthly communications that allow the venture capitalist to verify the management team's skills and to exercise his deliberation power during the shareholders' meeting. The company should communicate all information regarding risks that may affect: (1) the investment performance; (2) shareholders, directors, and employees; and (3) financial and operation data such as balance sheet reclassified, monthly financial plan, yearly budget and capital expenditures.

9.4.3 Team Commitment

The key element for a successful venture capital deal is the trust that the financial investor has in the expertise and management skills of the founders. Thus, it is reasonable to adopt a mechanism to ensure the stability of the property and the ongoing commitment and involvement of the entrepreneurs and key personnel. The most common terms are: stock options; lock up; permitted transfer clause; earn-out agreement; and exit ratchet.

Stock Options

Stock options can be assigned both to the management and to the founders to motivate and increase their desire to maximize the company's value. This is especially key when the venture capital investors together have the majority and need the full commitment of the key personnel working for the company. As stock options strictly fall within the compass of governance issues, a detailed analysis can be found in Chapter 11.

Lock Up

An agreement between the investor, existing shareholders and/or the management that prohibits them from exiting by selling their stock to third parties. It is wise to adopt a series of agreements connected with the transfer of the shares starting from the end of the lock-up period. The most important and frequent clause is the pre-emption clause, which gives the exiting partner the right to buy shares from an existing party. To ensure this clause is upheld, all parties assign their shares to an escrow agent, usually a trustee company, who will act according to the agreement signed by the parties so any opportunistic behaviour is avoided.

Permitted Transfer Clause

A provision between the investor and existing shareholders that prohibits both existing shareholders and private equity investors from selling their shares without the approval of the other party. This rule protects the stability of the parties' commitments and as such it could be considered a more sophisticated and flexible lock-up mechanism.

Earn Out Agreement

This is used mainly in private equity deals. It is a payment system consisting of a postponed payment of a part of the original acquisition price. This is done at the realization of defined performance indicators which are fixed a priori by a common agreement between the seller and the venture capitalist. This happens within a year or two after acquisition of the shares, and reduces the financial investor's economic risk.

Exit Ratchet

The exit ratchet provides an incentive for the entrepreneur (and manager). It allows to entrepreneur to obtain a part of the capital gain realized by the venture capital or private equity investor when the company's shares are re-allocated between the entrepreneur (and manager) and the venture capitalist. This ratchet is based on the periodic evaluation of the increasing value reached by the venture-backed company. It is a technique frequently adopted in leveraged buyout operations (especially in case of a management buyout or management buy-in, see Part IV of this book) combined with management objectives.

9.4.4 Other Terms

Staging Technique

This technique allows for financial resources to be invested in the firm in several staged instalments. The instalments are paid after specific business targets are hit (see Table 9.1). This provision ensures that the money is not squandered on unprofitable prospects and is also known as a 'tranched' investment. It is very common within venture capital investments where the venture-backed company doesn't need the injection of the whole amount at the beginning (e.g. to buy a plant or a machinery). It is common in investments in sciences-based companies for payments to be tranched, each tranche being measured against the achievement of agreed KPIs. These KPIs are measured against, for example, the different stages of development of one or more products, the company agreeing to take on new developments or the results of pre-clinical or clinical trials. It is common for the investors to be able to waive milestones or other completion conditions in the event of these events not being achieved.

Table 9.1 The content and the functioning of staging technique agreement

Tranches	Completion conditions	Completion mechanics
Initial tranche	The investors will stipulate that certain conditions must be satisfied before the initial tranche of the investment can proceed to completion. These conditions may include the following: • completion of any necessary due diligence in respect of the company; • the delivery of a satisfactory business plan and management accounts; • obtaining any required tax clearances; and • having the necessary authorities (board and shareholder) in place to issue the new shares to investors as part of the investment and adopting the new articles of association. The latter will likely require the passing of shareholder resolutions (whether by written resolution or by the holding of a general meeting) which may impact on: • when the investment can be completed, depending how quickly these resolutions can be passed; • the founders and key management having being issued shares or options; • the assignment in full of the necessary intellectual property rights owned by the founders or other persons to the company; • and appropriate insurance, such as keyperson and directors' and officers' liability insurance, being put in place.	These are the actions that need to be taken on the completion of the initial tranche of investment: • approval of the investment agreement and, if applicable, the disclosure letter; • issue of subscription shares and related certificates to the investors; • appointment of the investor director(s) to the board of directors; • an obligation on the investors to pay the subscription monies to the company's bank account; • approval and execution of service agreements if the founders are to become executive directors of the company; • and adoption of or commitment to adopt a share option plan. The investment agreement will stipulate that the proceeds of the investment (whether in the initial or subsequent tranches) must be used for achieving the agreed milestones and the realization of the agreed business plan or budget.
Subsequent tranches	It is typical for completion conditions to be attached to each subsequent tranche of investment. These would commonly include: • completion of the initial investment/ previous tranche; and • no material adverse change occurring (i.e. a negative event which impacts	These are the actions that need to be taken on the completion of the subsequent tranches of investment: • issue of new shares and related certificates to the investors; • and an obligation on the investors to pay the subscription monies to the company's bank accounts.

Table 9.1 (cont.)

Tranches	Completion conditions	Completion mechanics
	significantly on the business, the result of which may otherwise affect an investor's willingness to invest in a company); • the achievement of the agreed milestones related to the tranche in question; • there being no material breach of the investment agreement, the new articles of association or a director's service agreement; • the continuing employment by the company of the founders/certain key employees; • and the company not having entered into an insolvency event.	

Exclusivity and Confidentiality

The parties agree that the venture capital financing round shall exclusively be negotiated with the investors within the time window defined in the term sheet. As a consequence, within this period neither the company nor the holders of common shares may negotiate with other interested parties nor conclude any agreements with such parties concerning the financing of the company. With the consent of the investors, additional investors may accept this term sheet. If the negotiations cannot be completed within the time period set out in the term sheet, then the parties are no longer bound by this term sheet. The company and founders also agree to treat the term sheet confidentially and will not distribute or disclose its existence or contents outside the company without the consent of the lead investor, except as required to its shareholders and professional advisors.

Business Angels term sheets for startups

By Vincenzo Capizzi, Full Professor, Università Piemonte Orientale

The aim of this section is to clarify the most commonly proposed terms and conditions that are negotiated and signed when entering into a business angel investment (Chapter 3 goes into depth on this type of investor). These terms and conditions are usually included in a 'term sheet' or 'letter of intent' prepared by the startup or the business angel. Most of the terms are non-binding, with the exception of certain confidentiality provisions and, where applicable, exclusivity rights (see below).

Though, at a first glance, you may see little difference between an angel or seed investor term sheet and a venture capital term sheet, the investment structures and founder covenants required by angels are less constrained by standardized institutional practice. In fact, business angels use term sheets that offer less protection than venture capital term sheets, relying instead on their close relationship with entrepreneurs. They use term sheets that are not too detailed, costly or time consuming to design and negotiate. Angels' term sheets are typically quite short and may even be presented as a so-called 'one page term sheet', with provisions that are easier for the entrepreneur to digest and are based on alignment and fairness (See example in Appendix 2).

This brevity can be a mixed blessing. It allows founders and angels to reach tailored arrangements that suit the individual circumstances, even if the terms from an angel can sometimes omit to cover a number of potential future governance issues.

Angel Groups or Business Angel Networks (BAN) differ from this, in that they have put angel investing on a more professional footing, with more formal protection methods for risk, information asymmetries and agency costs. As a consequence, their contractual provisions and term sheets more closely resemble those of venture capitalists.

Key Provisions in an Angel Term Sheet

Startup founders should be familiar with the following five key provisions of an angel term sheet.

1. Investment Structure

Angel investment structures vary, but angels generally invest in one of three types of securities:

- Common shares;
- Convertible preferred shares; and
- Convertible debt.

Common and Preferred Shares

Common shares are residual value shares of the same class of those previously subscribed by the startup's founders. Convertible preferred shares (so-called 'Series A stocks') are shares that include a liquidation preference over common shares (with business angels' transactions, usually this is the original investment price), and are convertible into residual value common shares.

With common and convertible preferred share transactions, the parties will fix a valuation for the startup before investment (pre-money value, see Chapter 8), and this sets the price of the investment.

Convertible Debt

Angel investors often invest through convertible debt. This involves the investors lending money to the company, with the loan amount being convertible into equity shares of the startup.

The principal advantage of this structure is that the parties can defer fixing a valuation on the enterprise until a future financing round. When the future round is complete, the debt converts into equity shares at the purchase price determined at that time, sometimes subject to a discount of between 10 per cent and 25 per cent to reward the angel for investing early (see Chapter 8 for detail in convertible debt).

2. Key Economic Terms

Essentially, the key economic terms consist of:

- quantifying the preferred return of the investment; and
- quantifying any accruing earnings on the investment

Preferred Returns

Preferred returns represent an amount that the startup must return to the business angel before it distributes any assets (or payments) to other stakeholders. With business angels' deals, this amount should generally not exceed the original investment amount, and founders should negotiate any term sheet that proposes a different formula.

Accruing Returns

Accruing returns take the form of accrued dividends on equity shares, or of an accrued interest rate on convertible debt. It is rare in angel deals for this interest to be payable in cash. Rather, such amounts accrue and are converted into equity shares at the same time as the principal amount of the loan. The industry has no set standards for accruing return rates, but commonly the rates vary between 5 per cent and 12 per cent.

When negotiating these arrangements regarding convertible debt structures, founders should keep in mind the discount rate (if any) for the future purchase price. Angels typically do not ask for both a discount rate and accrued returns.

3. Board Structure and Reporting

While the practice is not uniform, angels often require some degree of formal representation on a startup's board of directors (either as a board member or appointed 'observer'), but they typically don't require control. Some will require certain reporting procedures (such as monthly sales or product development updates).

Generally, founders will agree to provide angels with reporting rights proportionate to the nature of their investment, provided that satisfying the obligations does not materially detract from the pursuit of the startup's objectives. Naturally, if a startup finds the right kind of angel investor capable of adding value to the business, the founders will willingly engage with those angels.

4. Corporate Governance and Shareholder Agreements

Angel investing almost always requires a shareholder agreement between the founder group and the new investors. When reviewing or crafting any proposal, there are some fundamental points entrepreneurs need to keep in mind:

- *Most angels are in your corner*: if you choose them wisely, most of the legal details that you negotiate will carry little significance. If you stumble, but communicate clearly the reasons for failure and the steps you have taken to address them, most angels will stick by you. (They wouldn't have invested in the first place if they didn't believe in the entrepreneur.)
- *Look forward to the next transaction*: notwithstanding the basic need to trust one another, founders should have a clear understanding of what it will take to change the shareholders' agreement and the share capital structure in the future. Consider carefully the pre-emptive rights provided to investors, or any consent rights over future financing rounds. If you have multiple angels, you can create a corporate governance regime that includes an independent evaluation of available alternatives and offers some protection against investor misfeasance or opportunism.
- *Regular, honest communication matters*: your conversation with angels (even passive ones) does not end at the closing. Whatever the actual terms of the shareholder agreement, it pays to recognize that the quality of a founder's personal relationship with his or her investors drives the tone of the company's governance. Considering all the other challenges a startup will face, adding unnecessary drama to the decision-making process amounts to bad management practice.

5. Due Diligence

The term sheet should define the timeline and process from the date of signing the term sheet to the closing date, as well as the conditions for closing, including due diligence. Most angel term sheets include some basic confidentiality obligations (especially if the proposed investors have not signed a non-disclosure agreement). Exclusivity covenants that require the startup to cease investment discussions with anyone else are less typically found, but some of the more organized angel syndicates do include these provisions in their standard term sheets. (If so, founders should aim to limit that period to no more than 30 to 60 days.)

See appendix for two term sheet examples.

KEY TAKEAWAYS

- The term sheet is the most crucial element in the negotiation between the entrepreneur (or shareholders) of the company and the equity investors. Its goal is to regulate their temporary partnership, leading to a successful exit.
- Within the negotiation process, choosing between the different categories of shares is a key contributory factor in finding the right balance between a venture capital investor's aims and the goals of the founders/entrepreneurs.
- Major covenants and mechanisms which, through their functioning and effects, help to regulate the relationship between the investors and the shareholders of the venture-backed company, play a fundamental role in the term sheet.
- Covenants can be classified into four main areas represented by economic rights, political rights, team commitment and other issues.
- Each covenant has a complete and effective status per se, with pros and cons that clearly identify the rationale for its usage. However, one of the main tasks of the negotiation process is to identify the group of covenants that, when taken together, mitigate the risk of conflict, enhance the liquidity event and the performance of the investment for the equity investor.

END OF CHAPTER QUESTIONS

1. What is the relationship between the negotiation process, the term sheet and the contracts underlying an investment of an equity investor into a venture-backed company?
2. What are the main areas of the negotiation process? In which ways are they linked together?
3. What are the main characteristics of shares involved in the negotiation

process? Why is it necessary to establish a hierarchy giving different rights or preferences to different capital investors?

4. Why is the equity investment defined as 'a temporary marriage'? What are the most sensitive areas when analyzing risks and potential conflict for the investor and the venture-backed company?
5. What is the main purpose of covenants and what is the rationale behind them? Can they help to completely eliminate risks and conflicts in an equity investment?
6. How are covenants classified?
7. What do we mean by liquidation preference? And what are the options available to regulate it?
8. What is the rationale for employing an anti-dilution mechanism? How does it operate and in favour of whom?
9. How does lock-up differ from permitted transfer? In what ways can they be considered similar?
10. Does a put option guarantee the liquidity event? If yes, why? If no, how can an equity investor sustain the liquidity event?
11. Which covenants maximize the opportunity for the equity investor to sell the company in the market? Why might the entrepreneur be in favour of these covenants?
12. What are the pros and the cons of combining a put option with a fixed strike price? How might this mechanism be improved from the perspective of the equity investor?
13. Do stock options allow the entrepreneur to have greater control of the company, or do they have a different aim?

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Let's Practise: Case Study

MONTE DEL VINO

It's October 2017. In a world excited by the promise of fintech startups and big data, Robert Barrel, a very bright guy, decides to launch a startup, buying an old-style brand name located in Tuscany that has produced fantastic wines for many years. 'Monte del Vino' has disappeared from the market and Robert wants to demonstrate that it is possible to sell a glamorous and traditional product such a great Tuscan red wine using new concepts and leveraging the power of the net to enhance the visibility and the awareness of the brand. Moreover, Robert wants to demonstrate to himself and to the world that he's a successful entrepreneur. He's also respectful of the traditions of the label, and despite wanting to buy the company, he wants to keep the son of the founder of the company and his brother on the board, as experts in growing grapes in Tuscany. He loves Tuscany and he decides to live there, to become a real hands-on entrepreneur.

Robert has got great ideas, but he needs an injection of cash, even though he has some million euros in his pocket from his last job as an investment banker. He decides to give his old MBA classmate, now partner at Alpha Investor, John Cash a call. John's reaction is positive he likes Tuscany and wine as well and he will provide Robert with feedback in a couple of weeks.

Two Weeks Later

John is smart and he understands that the potential is huge, and he knows Robert is the right person to do it. After dinner in a nice restaurant, they meet in the Alpha office in Milan the next morning and they start going through the deal. Facts and figures are on the table: the value of the company is €30 million and Robert is able to invest €12 million, i.e. everything he has got. John is ready to invest the missing €18 million and he declares he could stay as a shareholder in the company for three years, or four years at the most. Robert is familiar with the exiting requirements of equity investors; he also knows that Alpha is looking for a minimum return of 18 per cent (IRR). This is an existing business, and therefore not so risky as a new startup. Both know that he cannot give any guarantee to enhance liquidity.

The key figures of the business plan are the following, starting from 2017 (i.e. the year +1) in thousands of euros:

€000	2017	2018	2019	2020	2021	2022
Sales	37,000	41,000	45,000	45,000	48,000	52,000
Operating costs	31,000	33,000	35,000	35,000	37,000	40,000
EBITDA	**6,000**	**8,000**	**10,000**	**10,000**	**11,000**	**12,000**
Net income	3,564	4,917	6,917	6,617	7,284	8,117
Net Financial Debt	**5,000**	**4,500**	**4,500**	**4,000**	**4,000**	**3,500**

The Term Sheet

A week later, John is going to meet Robert to discuss the term sheet. Robert is ready to listen to what John is going to propose based on a €12 million investment (i.e. 40 per cent of stake) and a €18 million investment for Alpha (i.e. 60 per cent of stake). When he starts reading, the key conditions are:

- expected holding period for the investor: three years;
- put option with expiry date of three years and strike price and multiple of six; and
- in the absence of liquidity, use of a drag along mechanism.

Governance mechanisms haven't yet been written into the term sheet and John asks Robert to put forward a proposal on that issue. Robert wants to first evaluate the rules set out in the term sheet, and he's worried about the liquidity issue after three years. He goes home and he starts thinking about different alternatives to suggest to John, trying to find a balance (he was an investment banker, after all!) between the investor's expectations and his own expectations.

After a Long Night

Robert barely sleeps, and after a long night he's ready to meet John again to discuss alternative options, keeping the same amount of money on table: €12 and €18 million respectively. The first option is to try to reduce the percentage of John's stake: but will it be high enough for John? If the first option doesn't work for John, an alternative would be to postpone the drag along and to suggest a PIK mechanism where the equity investors increase their stake by 20 per cent more and agree to move the drag along to year four. Would that be a reasonable option for the equity investors? Another alternative would be to keep the status quo and just simply to postpone the same mechanism to year four. Again, would this be acceptable to the equity investors?

The puzzle isn't an easy one to solve, and you will have to help Robert to work out the results of each solution, to find other solutions and to be ready to discuss these with John, bearing in mind the 'marriage' must be convenient and effective for both partners.

Questions for Discussion

1. The case is based on different hypotheses to enhance private equity IRR. Please comment on the thinking expressed in the case.
2. Calculate the IRR with the three years put option.
3. Calculate the IRR with PIK mechanism.