Understanding the Venture Capital Term Sheet

Agenda

- This course will introduce you to the term sheet and also cover:
  - The respective negotiating positions of venture capitalists and entrepreneurs
  - How capital return expectations and timelines, valuation, control rights and liquidity influence these negotiating positions
  - How term sheets are used to manage potential differences at time of investment

About the presenter

Adam McGowan

amcgowan@wallstreetprep.com

- Former Investment Banker, Strategy Consultant & Corp. Fin.
- Firms: AOL, Booz Allen Hamilton, Capgemini, McNamee Lawrence

Overview

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The Allure of Venture Backed Companies…

- What's App's 450M users
  - $8M Series A
  - Assuming 20% ownership
  - $40M post-money valuation ($8M/.2)
- Facebook's $19B acquisition
  - $3.8B stake
  - Returned to a $1.3B fund

WhatsApp

Sources of Capital

Type	Pros	Cons
Founders	• No dilution • Points (Amex)	• Higher risk • Lack of liquidity
Crowdsourcing	• No equity stake • Market validation	• Public knowledge of ideas • New / potential fad?
Family & Friends	• Minimal equity stake • "Easy" ask	• Mixing business & family • Letting down Uncle Bob
Angel	• Minimal dilution • Good contacts	• Growing sophistication • Increasing expectations
Venture / Private Equity / Institutional	• Lots of capital chasing deals • Invaluable contacts	• Limited timeline • High expectations
Strategic / Corporate Investors	• Brand name / cache • Access to channel / customers	• Rights can limit some exits • Lack of strategic influence
Venture Debt / Convertible Debt / Bridge Loan	• Does not dilute equity(initially) • Provides additional runway	• High carrying costs • Only option?

"Revenue is the best investor"

Stages of Capital

- **Rounds**
  - Seed / start-up – angel, family & friends, founders, etc.
  - Early stage – Series A
  - Expansion – Series B / C
  - Late stage – Series C, D, etc.
- **Staged capital**
  - Pros:
    - Investors: control mechanism (go/no go), chance to double down or hedge risk
    - Entrepreneur: higher valuation if performing well
  - Cons:
    - Investors: potential to dilute ownership
    - Entrepreneur: it can be a full time job to raise funds – who is managing business?

Venture Capital Process / Timeline

Start-up Steps	Investor Pitch	Investor Decision	Term Sheet Negotiation	Document -ation	Sign, close & fund
4 weeks to 1+ years	1+ week to 6 months	1 – 3 weeks	2 – 4 weeks	2 – 8 weeks	1 – 3 days
• Formulation • Core team hiring • Patent filings	• Marketing • Meet (pester?) • Due diligence	• Due diligence • Final pitch • Partner review	• Deal terms • Valuation • Modeling	• Legal docs / entity • Due diligence • Gov't filings	• Fund • Budget • Build

"We won't look at any deal brought to us by a banker"

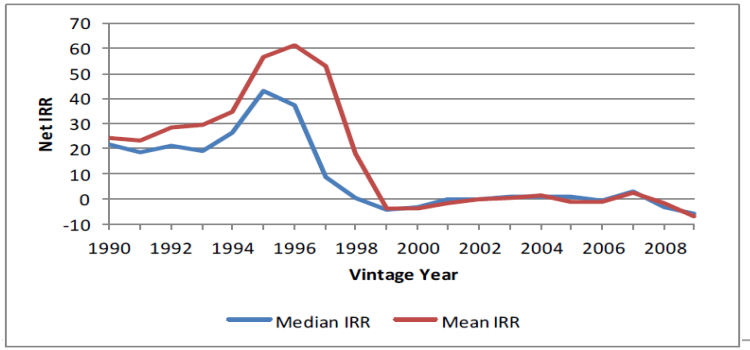
Venture Capital vs. Entrepreneur

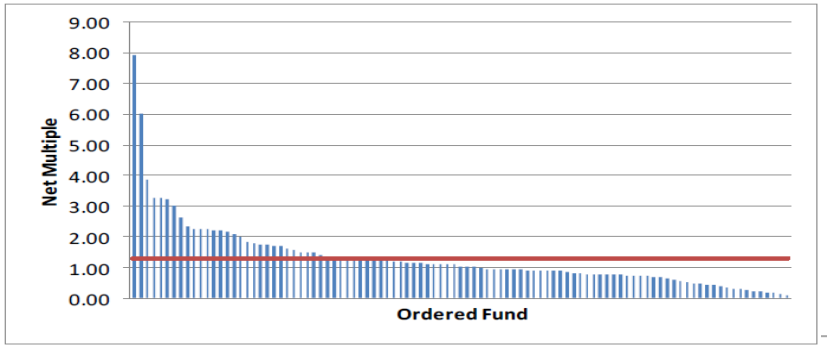
Venture Capital Goals:	Entrepreneur Goals:
• Maximize financial return of investment while mitigating risk • Help govern portfolio company's financial and strategic decisions • Provide additional capital if / when needed / warranted • Obtain liquidity through eventual sale or IPO • Return high rate of return on fund to LPs • Leverage success to raise additional capital	• Prove validity of business idea • Raise funds to operate business • Maintain control of company • Share some risk with financial backers • Establish operational success for company • Establish a profitable business (which no longer needs outside funding) • Achieve financial success (for self and management team) • Lead to next stage or repeat start-up process with new venture
Potential Sources of Conflict: • Control rights • Share of returns • Time to achieve outcome / liquidity • Definition of success / time to achieve	

Challenges

- Law of returns
  - Rule of thumb: for 10 VC investments, 20% (2) pay, 40% (4) break even & 40% (4) fail
  - Among venture firms, some big winners and lots of losers
- Fund Economics
  - To meet investor expectations, winners need to return a multiple of fund – harder for big fund to do with small investments
  - Incentives of 2% management fee & 20% carry returned to GPs
  - Limited life of fund; raise new funds while liquidating old
- Mitigation
  - Shared risk model with other venture firms
  - Staged capital

"The most significant misalignment occurs because LPs don't pay VCs to do what they say they will—generate returns that exceed the public market. Instead, VCs typically are paid a 2 percent management fee on committed capital and a 20 percent profit-sharing structure (known as "2 and 20"). This pays VCs more for raising bigger funds, and in many cases allows them to lock in high levels of fee-based personal income even when the general partner fails to return investor capital."





Net Return Multiple	No. of Funds
<1x	50
1x-<2x	33
2x-<3x	10
3x+	6

Valuation Drivers

- **In favor of venture capitalists:**
  - Illiquid investment – limited ability to sell securities before (or even following) an event (e.g. IPO); note private companies normally get a liquidity discount of 20%-30% vs. public companies
  - Uncertainty – discount entrepreneur's expectations of success
  - Added value – compensate for industry knowledge, contacts, guidance, etc.
  - Supply – more capital means higher valuations while less capital = lower valuations
- **In favor of entrepreneurs:**
  - Track record – past behavior does indicate future performance
  - Demand – competition from multiple interested investors can increase price
  - Timing / momentum – market cycle plays into perceived likelihood of exit

"Manage your business like you will run it forever, or you will"

Exercise 1: Return economics

- Assume a $100M venture fund with a 10 year life
- To achieve a 20% annual return, what multiple of original investment must fund pay, excluding fees? Please model.
- Assuming the firm makes approximately 20 investments and "law of returns" holds, how much do the investments need to return, again excluding fees? Is this realistic? Please model.
- Is a 100x return necessary for the fund to be successful? Again, assuming 20 investments are made, the VC will have one "home run" at a 100x multiple, three "doubles" at a 5.0x multiple, 8 singles at a 1.0x multiple and 8 "strikes" at a 0.0x return multiple. Please model.
- What does this imply about the size of the investment (i.e. does a smaller initial investment hold more promise of achieving return expectations)? To be discussed.
- What does this imply about the price at which VCs are willing to sell an investment? To be discussed.
- How do fees weigh into the conversation? To be discussed...

"The money is in the money"

Valuation

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Approaches to Start-Up Valuation

- Discounted Cash Flow (DCF)
  - Value a business based on future cash flows
  - Pros: academically sound, often tied to business model
  - Cons: negative cash flows, changing capital structure, assumption driven (g / WACC)
- Comps
  - Value a business based on like company trading / transaction multiples
  - Pros: easily calculated, market check
  - Cons: finding like companies (product, stage, etc.)
- VC Method
  - Work backwards from eventual exit (at desired rate of return) to find current value
  - Pros: based on above components, tied to expected return & ownership share
  - Cons: estimating timing and value at exit

Working Backwards Using the VC Method

- Step 1: Estimate investment needed
- Step 2: Forecast sales / earnings / cash flow
- Step 3: Determine timing of exit (IPO, M&A, etc.)
- Step 4: Calculate multiple at exit (based on comps)
- Step 5: Discount back to current day at desired rate of return
- Step 7: Determine post-money / pre-money / required ownership stake

Working Backwards Using the VC Method

- Step 1: Estimate investment needed
  - Startup.com needs a $7 million Series A
- Step 2: Forecast sales / earnings / cash flow
  - Startup.com is expected to grow accordingly:

$M	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Sales	1.0	3.1	7.2	15.5	$35.7	$50.0
Earnings	(5.0)	(7.5)	(0.2)	1.0	3.0	8.0

- Step 3: Determine timing of exit (IPO, M&A, etc.)
  - Investors plan to exit in year 5
- Step 4: Calculate multiple at exit (based on comps)
  - Companies in space are trading at 15x earnings
- Step 5: Discount back to current day at desired rate of return
  - Assume desired rate of return is 40%, exit value = $120/(1.4)^5 = $22.3M
- Step 7: Determine post-money / pre-money / required ownership stake
  - Post money = $22.3, pre-money = $15.3, VC ownership = $7/$22.3 = 31%

Pre-Money vs. Post-Money & Determining VC Stake

- Pre-money: value before financing round
- Post-money: value after financing round (pre-money + financing amount)
- VC stake expressed as a percentage of post-money
  - Example 1: $15 million pre-money valuation with a $10 million investment (aka $10 on $15)
  - $25 million post-money valuation ($15 + $10)
  - 40% ownership ($10/$25)
- Example 2: $5 on $10
  - $10M pre-money
  - $5M round
  - $15M post-money
  - 33% ownership

Valuation Calculations

- New investment = ownership percentage * post-money → $5M = 33.3%*$15M
- Pre-money = post-money – new investment → $10M = $15M - $5M
- Post-money = pre-money + new investment → $15M = $10M + $5M
- Post-money = new investment / ownership percentage → $15M = $5M/33.3%
- Post-money = new investment*(total outstanding shares post investment/shares for new investment) → $15M = $5M*(1,500,000/500,000)
- Share purchase price = pre-money / total outstanding shares pre-investment →$10 = $10M / 1,000,000
- Share purchase price = new investment / new shares → $10 = $5M / 500,000
- New shares issued = new investment / share purchase price → 500,000 = $5M / $10
- Total outstanding shares post-investment = total outstanding shares pre-investment + new shares issued → 1,500,000 = 1,000,000 + 500,000

Up vs. Down Round

- Up round
  - Pre-money of subsequent round greater than post money of previous round
  - Good for ownership share of original investors / founders
  - Normally a sign that business is performing well and multiple investors ("outside round") are interested
- Down round
  - Pre-money of subsequent round less than post money of previous round
  - Often results in dilution (lower equity stake for initial investors and/or founder)
  - Normally a sign business is not hitting its milestones; could be a sign of general health of venture investing
- Flat round
  - Pre-money of subsequent round equal to post money of previous round
  - Often a way to appease previous investors ("inside round")

"..not interested in leading next round or doing a down round...would rather run it full steam into the wall"

Exercise 2: Valuation Decisions

- Acme Co. is controlled by its founders (100% ownership)
- It has been able to grow to $35M in sales over a relatively short history
- Founders are exploring three potential options
  - Option 1: Sell the company today for a 3x revenue multiple (based on industry comps)
  - Option 2: Raise a $40M round of institutional capital (at 25% valuation discount to sale) to buy a distressed competitor ($20M in sales) with adjacent offerings and hope to sell at a higher revenue multiple (4x) in 3 years (assume no organic growth for simplicity and a 15% WACC)
  - Option 3: Take $40M off the table now to hedge some founder's risk but do not do the acquisition and hope to sell in 5 years at a 3.5x rev multiple (again, assume no organic growth and a 15% WACC)
- What should the founders do?
- What are good sensitivities to analyze in model? Please model data tables as shown.
- As a VC/PE/I-banker, how can you add value to the decision process?

Term Sheets

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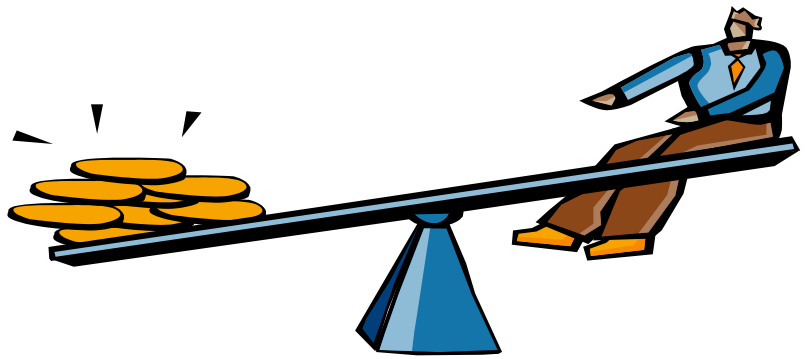
Term Sheet

- Short (<10 pages) document prepared by venture firm
- Main value is in laying out specifics of investment
- Meant to mitigate potential conflicts (financial and control) between investors and entrepreneurs
- Negotiable to a point
- Inability to protect / guarantee everything
- Not a legal document but considered binding (don't shop)
- Will form the basis of the cap table
- Will also feed into other legal docs (e.g. purchase agreement, voting agreements, etc.)
- Short term win vs. long term relationship → setting the stage

"I live by the golden rule, which is those that have the gold make the (expletive) rules"

Common vs. Preferred

Common:	Preferred:
• Founders / employees (options & RSUs) • Minimal rights (e.g. voting) & protection • Low cost basis • Goal is to incentivize founders and employees to work towards a successful outcome	• Venture capitalists (and sometimes founders) • Significant rights (e.g. liquidation preference) and protection (anti-dilution) • Higher cost basis • Goal is to minimize downside risk, especially in case of mediocre outcome, while ensuring right to participate in upside



Common Ways to Structure Investments

- **Convertible debt**
  - Debt a company issues that can be converted to common shares at a certain strike price
  - The conversion feature allows the corporation an opportunity to obtain equity capital without giving up more ownership control than necessary and/or entice investors to accept lower interest rates than they would normally accept on a straight debt issue
- **Convertible preferred**
  - May include a cash (or accrued - PIK) preferred dividend and is convertible into common
  - Enjoys significant privileges over common stock
    - Sits ahead of common stock
    - Typically has a liquidation preference (more on this shortly)
  - Majority of VC investments structured as preferred stock
    - VC receives preferred stock
    - Founders receive common stock
    - Employees receive options/common stock
  - Example: Initial investment of $1 million with conversion price of $5 / share → converts into 200,000 shares. If 600,000 shares of common outstanding, then own 25% of common on conversion (no div's.). Convert if .25*value > $1 million or value > $4 million

Preferred Stock Features

- Preferred shares: represent the number of preferred convertible shares currently outstanding – do not confuse this with shares authorized – as this number is typically much bigger
- Original issue price (OIP): represents the value of each preferred share
- Conversion ratio: the number of common shares that each convertible share can receive upon conversion
  - A similar concept is the conversion price, which represents the implied value of each share of common stock given the conversion ratio
- **Example**
- $25m investment will provide the investor with 3.1m shares of preferred shares, with OIP of $8.06, and conversion ratio of 2
- Preferred shares are convertible into 6.2m shares of common stock
- Since the initial investment is $25m, the conversion price into common stock is $25m/6.2m = $4.03.
- Alternatively, the conversion price can be calculated as: OIP/(Conversion ratio)

Preferred Dividends

- Dividends expressed on a per share basis: Preferred dividends are usually stated on a per share basis (1m preferred shares with a $0.08 per share dividend).
- Dividends expressed as a % coupon: Sometimes the dividend is expressed as a coupon as a % of the face value of the obligation ($25m face value investment with a 13% dividend).
- Dividends can be cash dividends, or often they are PIK (accrued) dividends, meaning they increase the value of the liquidation preference every year
- Preferred dividend yield = $\frac{dividends\ per\ share}{OIP}$
- **Example:** $25m investment with a 13% coupon PIK dividend means that (as long as the preferred shareholders do not redeem their investment or convert their shares into common stock) the liquidation preference grows every year by 13% such that:

Preference After Year 1 Dividend	$28,250,000
Preference After Year 2 Dividend	$31,922,500
Preference After Year 3 Dividend	$36,072,425
Preference After Year 4 Dividend	$40,761,840
Preference After Year 5 Dividend	$46,060,879
Preference After Year 6 Dividend	$52,048,794
And so on….	

Liquidation Preference

- Preferred stock term sheet almost always includes a liquidation preference.
  - VCs get money back before common gets anything
- Gives the investor the option – in a liquidity event– of either receiving their liquidation preference as their return or converting into common stock and receiving their percentage ownership as their return.
- Liquidation preference represents the amount the company must pay at exit (after secured debt, trade creditors, and other company obligations)
- Liquidation preference determines the relative distribution between the preferred shareholders (the investors) and the common shareholders.
- The liquidation preference is often expressed as a multiple (i.e. 1.0x) of the initial investment:
  - $Liquidation\ preference = Investment * liquidation\ preference\ multiple$

Types of Liquidation Preferences

- 1) Non-participating preference (1x or multiple) – "straight preferred"
  - At exit investors choose between a return of capital (sometimes partial) and participation with the common shareholders in proportion to their ownership. (See example below.)
  - If investors choose return of capital, any remaining proceeds are divided among common shareholders
  - Example: $25m investment with a 1.2x liquidation preference multiple implies that if the investors choose not to convert to common stock, the company must redeem the obligation at no less than 1.2x * $25m = $30m at exit. Any remaining proceeds flow down to common shareholders. Had the investors chosen to convert, they would have shared in the proceeds pro rata with the common shareholders (which could be more or less than preference, depending on ownership % and amount of proceeds)

Types of Liquidation Preferences

- 2) Participating 1x liquidation preference – "participating preferred", "full participating preferred", "participating preferred with no cap"
  - In this structure (sometimes called "double dipping"), investors first receive their capital (1x preference) and then their shares convert to common
  - First returning capital to preferred investors
  - Then distributing the gains from the sale of the company in proportion to (pro rata) ownership, but including the preferred investors on the second distribution on an as-converted basis
  - Example: $10M post-money valuation (VCs invested $5M), that sells for $30M with a 1x liquidation participation, VCs get $5M ($5M x 1), then 50% of remaining $25M, or $12.5M, for a total of $17.5M vs. $12.5M for employees → 50%/50% ownership vs. 58%/42% share

Types of Liquidation Preferences

- 3) Capped participation – “capped participating preferred”
  - Capped participation indicates that the stock will share in the liquidation proceeds on a pro rata basis until total proceeds reach a certain multiple of the original investment (plus any accrued dividends)
  - Example: 2x cap (1x pref) on a $5M investment that gave 50% ownership. If the exit = $25M, the VC’s capped proceeds of $10M ($5M + <<.5*$20M) is less than had it converted and received $12.5M (.5*$25M)

Liquidation Preferences Features

- Liquidation preferences protect the downside of preferred investors
- In environments when capital is scarce, liquidation preferences carry higher multiples than 1x (in certain circumstances even as high as 5x or 7x or more) preferences although this is rare – "multiple liquidation participating preferred"
  - **Example:** $10M post-money valuation (VCs invested $5M), that sells for $30M with a 3x multiple liquidation participation, VCs get $15M ($5M x 3), then 50% of remaining $15M, or $7.5M, for a total of $22.5M vs. $7.5M for employees → 50%/50% ownership vs. 75%/25% share→ even more drastic at lower exits
- Preferences vis-a-vis multiple classes of stock
  - Liquidation preferences are generally structured on a first-in, last out (FILO) basis
  - In other words, the latest investors "stacked" their preferences on top of each other (i.e. series B gets its preference first, then series A)
  - An alternative is where the series are equivalent in status ("pari passu") where series A and B share pro-ratably until the preferences are returned.

Liquidation Preferences Examples

- Three outcomes for an investor investing $1 million for 25 percent of a company later sold for $2 million:
  - No liquidation preference: without a liquidation preference, investors get only $500,000 (25% of proceeds), losing half of their capital, and entrepreneurs receive $1.5M.
  - Non-participating 1x liquidation preference: Investors would get $1 million from the preference, with common getting the remaining $1 million.
  - Participating 1x liquidation preference: Preferred investors get $1 million off the top plus another $250,000 (25 percent of the remaining $1 million). The common shareholders would receive $750,000.
  - Participating 1x liquidation preference with 2x cap: Preferred investors get $1 million off the top plus another $250,000 (cap does not go into effect).

Redeemable Preferred Stock

- The company may incorporate the ability to repay the investors into the capital raise.
- Restrictions on how quickly the preferred stock can be redeemed (for example, a term sheet may stipulate that the preference is not redeemable until two years after the initial investment)
- When preferred stock is redeemable, another feature is a redemption premium (also called call premium for bonds). This feature allows companies to redeem at a premium (often expressed as a %) above the face value of the preference amount. The investment premium can vary year by year.
  - Example: Revisiting our example for a $25m investment with a 13% PIK dividend, imagine the investors structured the investment such that preferred stock was not redeemable for the first two years, and then it would be redeemable in year 3 with a redemption premium of 6%, year 4 with a redemption premium of 3%, and no premium thereafter. Assuming the same 13% PIK dividend, the redemption amount would be:

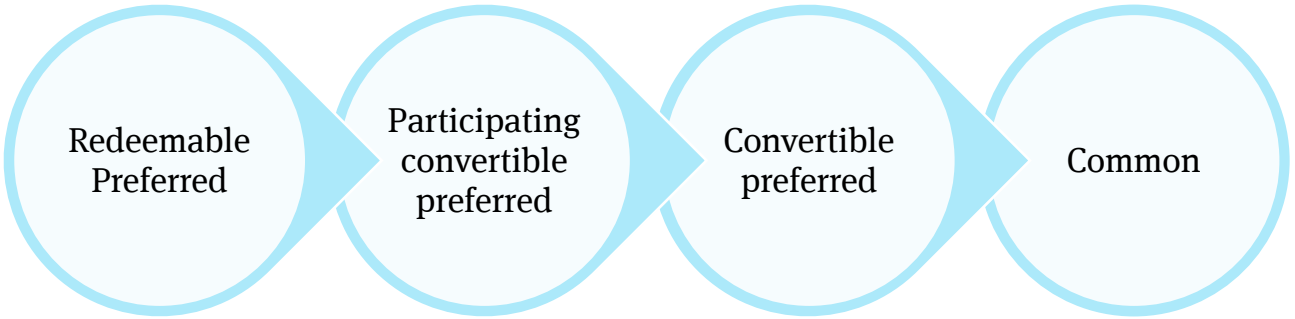
Redeemable Preferred Stock

	Preference Amt.	Redemption Amt.	Redemption Premium
Preferred Coupon	13.0%		
Preference After Year 1 Dividend	$28,250,000	Not Redeemable	
Preference After Year 2 Dividend	$31,922,500	Not Redeemable	
Preference After Year 3 Dividend	$36,072,425	38,236,771	106.0%
Preference After Year 4 Dividend	$40,761,840	41,984,695	103.0%
Preference After Year 5 Dividend	$46,060,879	46,060,879	100.0%
Preference After Year 6 Dividend	$52,048,794	52,048,794	100.0%

Evolution of Preferred Stock

- 1970's – 80's: Redeemable preferred
  - Not an active IPO market
- 1980's – 90's: Convertible preferred
  - Active IPO market
  - More funds
- 1990's – 2000's: Participating convertible preferred
  - Increasing valuations
  - Less active IPO market

Use of securities as an incentive (carrot or stick?)



Other Items to Negotiate

- Composition of board of directors
  - Usually a mix of founders, VCs, and outside advisors' 4-6 people on average
  - Composition (majority) often driven by % ownership
- Size of the employee option pool
  - Percentage of stock reserved for key employees (existing and new hires)
  - On average, ~20% reserved for option pool which generally comes out of founder pool; key employees range from <1% to 10% (depending on round)
- Vesting of employee shares
  - Vested shares generally tied to time or milestones; can be accelerated or upfront
  - Unvested shares can be bought back by company (for little if anything) in case of termination or quitting

Other Items to Negotiate

- Anti-dilution
  - Protection for VCs in case of a down round, so that their conversion ratio to common stays equal to new investors
  - Full ratchet means previous round is priced to the next round's lower price
    - Formula: new conversion price = lower price of down round
    - Example: old conversion price of $1, new conversion price of $0.50, new issue of 500K shares; old common of 2 million; old preferred of 2 million
    - Old convertible preferred now own 62% or 4 million / 6.5 million

Other Items to Negotiate

- Anti-dilution
  - Weighted average takes into account the number of new shares issued in lower next round
    - Formula: new conversion price = (# of common before new investment + # of shares to be issued if old conversion price held) / (# of common before new investment + # of shares issued under new conversion price) * old conversion price
    - New shares to initial preferred investors = (old price / new price) * initial shares
    - Example: old conversion price of $1, new conversion price of $0.50, new issue of 500K shares; old common of 2 million; old preferred of 2 million
    - New conversion price = (4 million + 250K) / (4 million + 500K)*$1 = $0.944
    - Convertible preferred now own 45.9% or ($1/$0.944)*2 million = 2,117,648; 2,117,648/(2,117,648+2,000,000+500,000)

Other Items to Negotiate

- Redemption rights
  - Force timing of redemption of preferred by company through purchase at fair market value; if company can not redeem, then penalties (e.g. decrease conversion price)
- Registration rights
  - Right to register shares with SEC so that investor can sell on public market
- Pay to play provisions
  - Preferred shareholders lose anti-dilution protection unless they invest in next round at lower price; normally preferred will automatically convert to common in such a case
- Rights of first refusal
  - Right to buy shares being sold by any shareholders; prevents dilution

Other Items to Negotiate

- Preemptive rights
  - Right to buy shares offered in subsequent financing rounds
- Information rights
  - Right for preferred shareholders to get a copy of quarterly / annual financials, etc.
- Piggyback registration rights
  - Investors can include shares along side company in an IPO
- Drag along rights
  - All shareholders must sell if board and/or majority shareholders approve
- Tag along rights
  - An offer for a shareholder's stake must be offered to all shareholders

Exercise 3: Term Sheet Translation

- From the dividends section:
  - "Dividends: The holders of the Series A Preferred shall be entitled to receive cumulative, non-compounding dividends in preference to any dividend on the Common Stock at the rate of 10% of the Original Purchase Price per annum. The holders of Series A Preferred also shall be entitled to participate pro rata in any dividends paid on the Common Stock on an as-if-converted basis."
  - Scenario 1: Assume a $10M initial investment, how long will it take for dividends to achieve a 5x return. What is not factored into calculation? What is the purpose of dividends?
  - Scenario 2: Assume a $40M investment (straight preferred) which bought 40% of company and five years later trades for $80M. Calculate post-money. What is the value of dividends here? What does this say about dividends?