

Term Sheets in VC

- Educational Presentation 8 – Venture Capital
- 06.02.2024
- Property of the ESCP Alternative Investments Society
- Pitchbook, Dealroom, Wall Street Prep

Section I: Introduction to Term Sheets

What is a Term Sheet?

Understanding the foundation of any VC deal

Features of a Term Sheet

- Non-binding agreement between a startup and a potential investor
- Outlines key terms and conditions of a potential investment
- Term sheet summarizes the information on 5 to 10 pages
- Facilitates the investment process but implies no investment obligation
- Used to draft final agreement

Applications of Term Sheets



Venture Capital Investment



Joint Venture & Strategic Partnerships



Convertible Notes & SAFE Agreements



Co-Founder Agreement



Employee Stock Options & Equity Grants

Outline

To work through a term sheet, we will use the following 5-step approach:

1. Valuation and Investment Amount: Pre-Money, Post-Money Valuation & Capital Investment



2. Liquidation Preference: Specifies how investors get paid in case of an exit



3. Anti-Dilution Protection: Defines how investor shares are adjusted in future funding rounds



4. Governance and Board Structure: Number of seats and voting rights for founders and investors



5. Exit Rights and Founder Restrictions: States the terms on how to exit from an investment

Key Terms in Term Sheets

Equity Stake: Percentage of the company an investor will own

Option Pool: Reserved percentage of equity for future employee stock option

Valuation Cap: Maximum Valuation at which convertible securities (like SAFEs or convertible notes) convert into equity

Discount: Reduction on the share price that early investors receive in future funding rounds

Section II: Valuation in Term Sheets

Understanding Valuation in a VC Context

The Venture Capital Method is used to value startups based on expected exit value and required investor returns

Pre-Money Valuation

- 1 The pre-money valuation is the startup's estimated value before receiving a new investment
- 2 Determines how much ownership stake investors receive for their money
- 3 Founders aim for a high valuation because they will receive more money per share
- 4 Founders must assess pre-money valuation carefully to avoid excessive dilution
- 5 A higher pre-money valuation signals growth potential but may hinder future rounds, while a lower valuation attracts investors but increases dilution

Post-Money Valuation

- 1 The value of a company after receiving new funding through an investor
- 2 Determines the investor's equity stake in the startup
- 3 Post-money Valuation helps founders to assess the retainment of control after an investment
- 4 Investors evaluate post-money valuation to estimate potential exit returns (IPO, Acquisition, etc.)
- 5 Affects how much investors need the company to grow, in order to achieve a Target Return Multiple (e.g. 10x ROI)

Valuation of Early-Stage Startups

Explanation of Venture Capital Method

The method works by estimating the future exit value, applying a target return multiple and working backward to determine today's valuation

	Process	Formula
1	Estimate Future Exit Value	= Projected Revenue at exit x industry multiple
2	Determine Target return Multiple based on risk of the investment	Higher Risk = Higher multiple (10x - 30x for early-stage)
3	Calculate Post-Money Valuation	= Exit Value / Target Return
4	Calculate Pre-Money Valuation	= Post-Money Valuation - Investment
5	Determine Ownership Stake	= Investment / Post-Money Valuation

Valuation of Early-Stage Startups

Example of Venture Capital Method

	Formula	Example
1	= Projected Revenue at exit x industry multiple	
2	Higher Risk = Higher multiple (10x - 30x for early stage)	
3	= Exit Value / Target Return	
4	= Post-Money Valuation - Investment	
5	= Investment / Post-Money Valuation	

Understanding Capitalization Tables

A “Cap Table” outlines the equity ownership of a startup, listing shareholders, share classes and dilution effects after new investment rounds

Ownership and Investment Sizes	Shows the division of equity between investors, founders and employees and furthermore highlights how much capital is to be invested in the next round
Stock Classes and Liquidation Preferences	Differentiates between common and preferred shares, outlining investor rights, voting power and who gets paid first in the case of an exit
New Shares and Options in the Round	Portrays how new shares issued in a funding round or option pool expansion affect existing shareholder ownership
Valuation and Share Price Calculation	Calculates share price using pre- and post-money valuation to clarify how much equity investors receive and how ownership is distributed
Exit Calculations	Estimates investor payouts in different exit scenarios based on ownership stakes and liquidation preferences, thereby helping VCs to project potential returns on their investment

Capitalization Tables: Example (1/3 – Seed Round)

Key Inputs:

- Investment amount, pre- and post-money valuations, special terms
- Employee stock options and co-founder/manager free shares

Pre-Investment Cap Table:

- Three co-founders, each owning 33% before funding

Seed Round Details:

- Investment: \$2M at a \$6M pre-money valuation
- Post-Money Valuation: \$8M (\$6M + \$2M)
- Investor Ownership: 25% (\$2M / \$8M)

Liquidation Preferences:

- Investors receive 1x liquidation preference → \$2M minimum payout at exit

Employee Stock Options:

- If granted before the round and set at 10% ownership:
Shares Calculation: $1.2M / (1 - 10\%)$
* 10% = 133,333 options granted
- Post-round dilution reduces options below 10%, requiring adjustments

Capitalization Tables: Example (2/3 – Series A)

Series A Investment:

- Investment: \$5M at a \$15M pre-money valuation
- Post-Money Valuation: \$20M (\$15M + \$5M)

Ownership Split:

- VCs own 25% (\$5M / \$20M)
- Employee options pool increases to 20% total ownership
- Remaining 55% is held by existing shareholders (co-founders & Seed investors)

New Shares Issued:

- Pre-round shares: 1.778M
- Adjust for 55% retained ownership → Total post-round shares: ~3.0M
- New shares issued: ~1.2M
- Employee options: 465K (to reach 20% total).
- Series A VCs: 747K shares (to reach 25% ownership).

Share Price Calculation – 2 Methods:

Method 1: Investment / Shares Purchased → $\$5\text{M} / 747\text{K} = \6.69 per share

Method 2: Pre-Money Valuation / (Pre-Money Shares + Free Shares) → $\$15\text{M} / (1.8\text{M} + 465\text{K}) = \6.69 per share

Capitalization Tables: Example (3/3 – Exit Analysis)

Exit Proceeds Calculation:

- If the startup sells for \$100M, each group's payout
= Ownership % × \$100M
- Assumes all investors convert to common shares for a higher return.

Liquidation Preferences Impact:

- If the exit value is low (\$18M), investors may retain preferred shares. Series A VCs (25%) get \$5M liquidation preference (better than \$4.5M from common)
- Remaining \$13M is distributed among other shareholders

Seed Investors' Adjusted Ownership:

- Original: 14.9%, but after Series A takes \$5M, their effective stake increases
- Adjusted ownership: 19.8% of remaining \$13M → \$2.6M
- Since \$2.6M exceeds their \$2M liquidation preference, they convert to common shares

Key Takeaways:

- Liquidation preferences significantly impact proceeds in low exit value cases
- A detailed cap table is crucial for accurate payout modeling

Section III: Liquidation Preferences

Liquidation Preference (1/3)

Introduction to Participation

- After agreeing on the company's valuation, the liquidation preference attaching to the preference shares is the next in the term sheet
- The liquidation preference determines the order in which proceeds are being paid out on a liquidity event (e.g. sale), providing a downside protection as it allows the holder of the preferred share to be paid first when proceeds are being distributed
- There are two components to the liquidation preference: 1) the Participation 2) the Multiple

Non-Participating

- Investor choice: Fixed return or convert to common stock
- Limited Return: No extra participation in upside

Payout = Investment Amount × Liquidation Multiple + Unpaid Dividends

Participating Preferred

- Upfront Recovery: Investor receives liquidation preference upfront
- Shared Proceeds: Investor participates in remaining proceeds

Total Payout = (Liquidation Preference) + (Pro-Rata Share of Remaining Proceeds)

Participation Cap

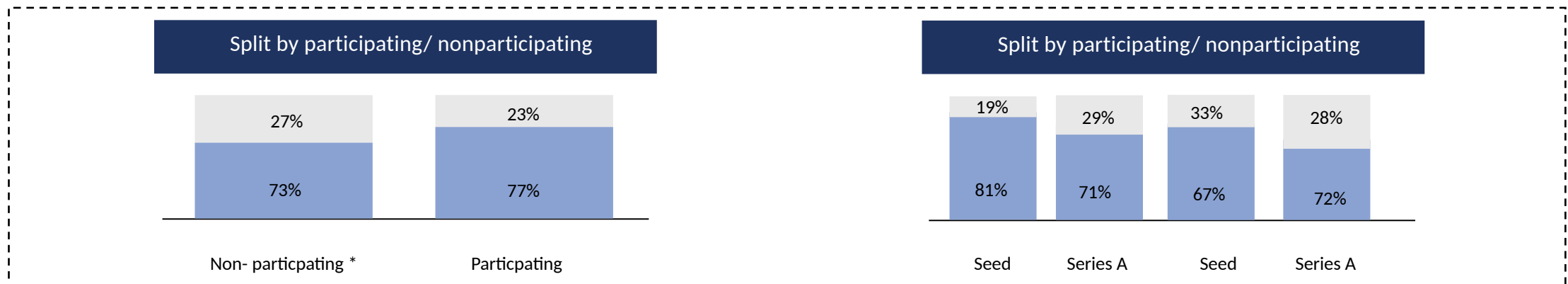
- Return Cap: Restricts maximum payout under liquidation preference
- Conversion Flexibility: Allows conversion to common shares for higher returns

Total Payout = min(Cap, Liquidation Preference + Pro-Rata Share of Remaining Proceeds)

Liquidation Preference (2/3)

Introduction to Multiples

- Liquidation preferences have a multiple attached (e.g., 1x, 2x). This means the preferred shareholder gets one (1x) or two times (2x) their original investment amount back before the shareholders below them in the priority stack
- The liquidation preference priority stack in the term sheet sets out the order in which the preferred shareholders get paid out on exit. As a company raises a new round, later investors may want their own rights and benefits, which could be superior to the earlier investors.
- Standard: Liquidation preferences are ranked in order from the latest to the earliest round. This may mean earlier investors are more at risk of receiving a small return or nothing at all
- Pari Passu: Investors from all funding rounds are considered equal and receive proceeds in proportion to their investment amount



* Participation including Participation Cap

Liquidation Preference (3/3)

Example 1: \$2m investment, 50% ownership, 1x **non-participating preference**

- Investment amount: **\$2m**
- Preferred equity: **50%**
- Ordinary equity: **50%**
- Liquidation preference: **1x**
- Participation: **No**
- Exit proceeds: **\$10m**

Total exit proceeds: \$10m	
Pro rata- covert preferred to ordinary equity \$5m	Ordinary (Founder) equity at 50% - \$5m
1x liquidation preference would result in only \$2m return, so the investor would convert to ordinary shares. The investor gets a portion of the proceeds based on their pro-rata ownership (50%), i.e., \$5m	Founders also get 50% of the exit proceeds, i.e., \$5m

Example 2: \$2m investment, 50% ownership, 1x **non-participating preference**

- Investment amount: **\$2m**
- Preferred equity: **50%**
- Ordinary equity: **50%**
- Liquidation preference: **1x**
- Participation: **No**
- Exit proceeds: **\$3m**

Total exit proceeds: \$3m	
1x liquidation preference: \$2m	Ordinary (Founder) equity at 50% - \$5m
Exercising the 1x liquidation preference gives \$2m of the exit proceeds, compared to \$1.5m from converting to ordinary equity. Thus, the investor opts for the liquidation preference	Exit proceeds for the founder reduced to \$1m (the residual amount) because of the investor exercising their liquidation preference

Example 3: Investor has invested \$2m for 50% of the company and has a 1x **participating preference**

- Investment amount: **\$2m**
- Preferred equity: **50%**
- Ordinary equity: **50%**
- Liquidation preference: **1x**
- Participation: **Yes**
- Exit proceeds: **\$10m**

Total exit proceeds: \$10m		
1x participation liquidation preference: \$2m	Participation as ordinary shareholder at 50%: \$4m	Ordinary (Founders) equity: \$4m
Investor exercises participation liquidation preference	Investor 'double dips' and receives a proportion (50%) of the remaining exit proceeds (£8m), therefore \$4m	Ordinary shareholders receive the remainder (in this case 40%), albeit owning 50%

Understanding Anti-Dilution

The two different types of anti-dilution provisions used to safeguard investor ownership

- Anti-dilution provisions protect investors' investment value in the event of a future down round, where new shares are issued to new investors at a lower price. Incumbent investors have the right to receive additional shares at no or minimal cost to compensate for their dilution

Weighted Average Anti-Dilution

A weighted average ratchet anti-dilution provision can be:

- Narrow-based: Only the actual number of shares in issue are taken into account
- Broad-based: Both the shares in issue and any outstanding options are considered

$$\text{New Conversion Price} = (\text{Old Price} \times \text{Pre-Money Share} + (\text{New Investment} / \text{Old Price})) / \text{Pre-Money Shares} + \text{New Shares Issued}$$

Full Ratchet Anti-Dilution

- A "full ratchet" anti-dilution provision means that if the company issues shares at a price lower than the price for the series with the full ratchet provision, the earlier round price is effectively reduced to the price of the new issuance
- A full ratchet adjustment is the most aggressive form of anti-dilution protection. It provides the greatest protection to the investor and has the greatest negative impact on founders, employees, and ordinary shareholders

$$\text{New Conversion Price} = \text{Price Per Share in Down Run}$$

Section IV: Control Terms

Pay-to-Play Provisions and Investor Incentives

Pay-to-play provisions require existing investors to participate in future financing rounds to maintain their preferred rights

Key Mechanism

- Valuation Reset: The company's valuation is often lowered, forcing investors to invest at a lower price or risk dilution
- Pro Rata Requirement: Investors must contribute proportionally to maintain their ownership stake
- Cram-Down Effect: Non-participating investors experience a reduction in ownership through reverse stock splits, diluting their shares



Existing Investors perspective

- Encourages active investor participation
- Prevents inactive investors from benefiting from future growth without contribution
- Forces out smaller investors or funds with depleted reserves

Founders and Common Shareholders Perspective

- Can significantly dilute existing founders, employees, and angel investors
- Creates boardroom tensions and potential conflicts among investors
- May act as a last-resort strategy when raising capital in difficult market conditions

Dividends – Cumulative vs. Non-Cumulative

Dividends are payments made to shareholders from a company's earnings. In venture financing, they can be cumulative or non-cumulative

Feature	Cumulative features	Non – Cumulative Features
Accumulates if unpaid	Accrual	Does not accumulate
Payment Obligation	Must be paid before common stock dividends	Paid only when declared
Investor Benefit	Ensures a minimum return	More flexible and aligned with cashflow
Founder Consideration	Creates a financial liability	Avoids accumulating obligations

Market Standard

- Varies by deal structure. Many early-stage startups avoid cumulative dividends to preserve cash.
- Founders should negotiate for non-cumulative dividends to maintain financial flexibility.

Redemption Rights – Investor vs. Company Perspective

Redemption rights give investors the ability to sell shares back to the company after a predefined period, typically in the absence of an exit event



Challenges and Market Realities

- When exercised, the company is obligated to repurchase the investor's shares at a pre-agreed redemption price
- Investors may receive their initial investment, accrued dividends, and any additional profits
- The redemption price is typically specified in the corporate charter and can include penalty provisions if not paid on time, such as (e.g., Issuance of a promissory note for the redemption amount, gaining control of the board of directors until payment is completed)

Investors VS Founder Perspectives

- **Investor Perspective**
 - Mitigates risk by ensuring financial protection if growth targets are not met
 - Guarantees a fixed return, even in the event of a lower-than-expected IPO valuation
 - Strengthens investor influence through enhanced voting rights
- **Founder Perspective**
 - Can create financial strain from redemption obligations
 - Limits flexibility, especially with low cash reserves.
 - Often negotiated with profitability-based restrictions

Board Structure

The Board governs strategy, decision-making, and investor oversight

Investor Representation

- **Series A+:** VCs typically demand Board seats
- **Lead Investor Seat:** Often assigned when multiple investors are involved
- **Observers:** Non-voting, attend meetings, influence discussions

Board Control Dynamics

- **Early-stage:** Founders control the Board; investors hold consent rights on key decisions
- **Later-stage:** Investors gain influence, Board composition shifts
- **Swamping Rights:** Investors may take control in cases of financial distress or governance issues. Founders should negotiate to limit these clauses

Key Considerations

- Ensure alignment with Board members
- Set a 5%+ ownership threshold for investor Board seats to prevent excessive representation
- Carefully review and limit swamping rights to maintain control
- Plan for Board restructuring in future funding rounds

Founder Vesting

Founder Vesting is the process through which founders earn back their shares over a set period following a fundraising round. If a founder leaves before the vesting period concludes, unvested shares are typically reclaimed and can be used to attract replacement hires.

Key Elements of Founder Vesting

- 1 Initial Vesting Percentage
 - The proportion of shares that are vested on day one, with the remainder subject to a vesting schedule
- 2 Vesting Methodology & Duration
 - Straight-line vesting: Shares vest monthly, quarterly, or annually over the agreed term
 - Cliff vesting: A portion of shares vests only after a specific period (e.g., one year), ensuring a minimum commitment before any ownership accrues
- 3 Good Leaver vs. Bad Leaver Provisions
 - Determines the fate of shares when a founder exits

VCs vs Entrepreneur's Perspective on Founder Vesting

VCs Perspective

- Ensures Commitment: Protects their investment by keeping founders engaged long-term
- Reduces Risk: Prevents early departures with significant equity stakes
- Encourages Value Alignment: Motivates founders to stay and build the company
- Provides Flexibility: Allows reallocation of unvested shares if a founder exits

Entrepreneur's Perspective

- Limits Control: Seen as an investor tool to retain leverage over founders
- Undervalues Prior Contributions: Founders may negotiate for pre-vested shares if they've already built value

Drag, Tag-Along and Co-Sale Rights

Drag-Along (-82% of term sheets include clause)

- Allow majority shareholders to force minority shareholders to sell under the same acquisition terms
- Ensure full ownership transfer, preventing minority shareholders from blocking deals
- Triggered by a negotiated shareholder approval threshold

Tag-Along (-63% of term sheets include clause)

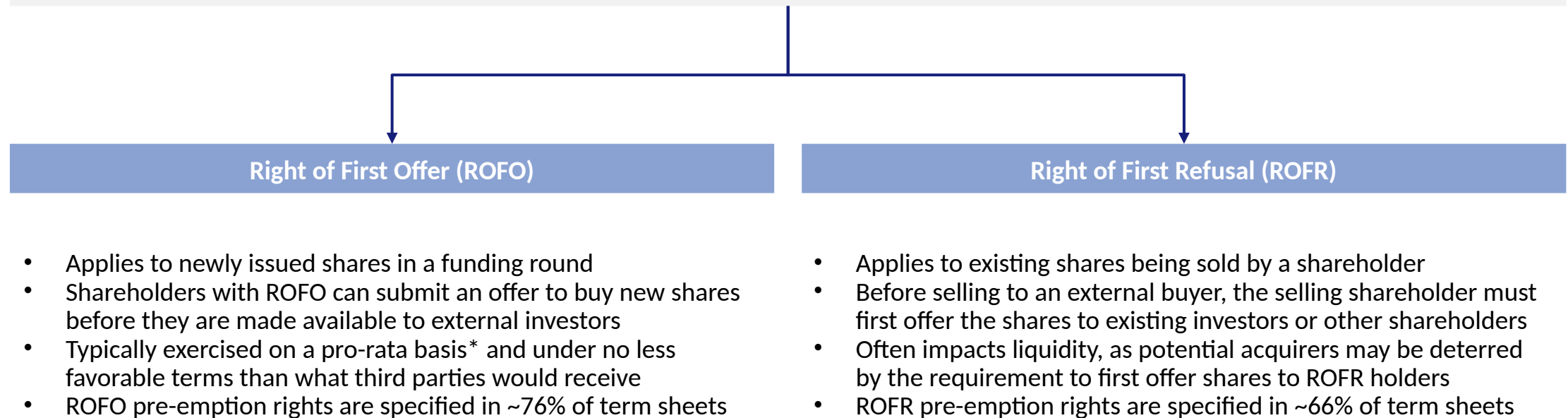
- Provide minority shareholders the right to participate in a sale alongside majority shareholders on identical terms
- Protects minority investors from being left behind in a transaction where controlling shareholders exit
- Ensures that any liquidity event benefits all shareholders proportionally, subject to liquidation preferences

Co-Sale (-63% of term sheets include clause)

- Allow investors, especially preferred shareholders, to sell shares proportionally when majority owners exit
- Prevent key shareholders from cashing out without offering similar opportunities
- Often paired with Right of First Refusal (ROFR) to prioritize internal sales

Pre-emption Rights – ROFO & ROFR

Pre-emption rights give existing shareholders the priority to buy additional shares before they are offered to third parties, ensuring they can maintain their proportional ownership. There are two main types of pre-emption rights:



* Pro-rata means "in proportion to ownership." If a shareholder owns 10% of a company and new shares are issued, a pro-rata right allows them to purchase 10% of the newly issued shares to maintain their stake.

Section V: Other Terms

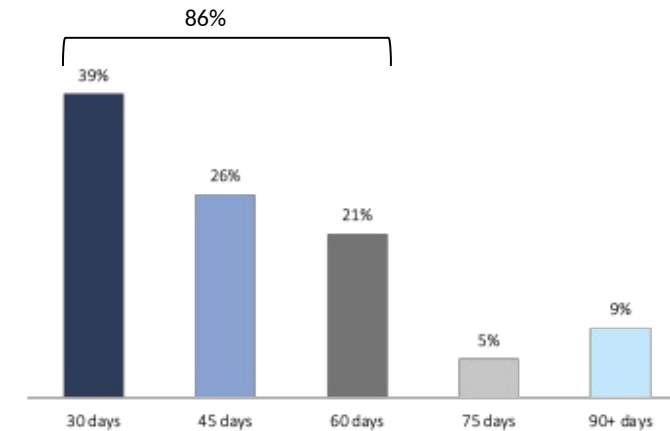
Exclusivity Period

The exclusivity period is a legally binding clause in VC term sheets that prevents the company from negotiating with other investors for a set time while the lead investor conducts due diligence. Typically, exclusivity lasts between a few weeks and 90 days.

Key Aspects of the Exclusivity Period

- Ensures investors have sufficient time for due diligence without the risk of competing offers
- Typically included in 66% of term sheets, with 86% of specified periods lasting 60 days or less
- Protects investors but can limit a company's ability to seek better terms or alternative funding

Duration of the Exclusivity Period



Section VI: Application of Term Sheets

From Term Sheet to a Binding Agreement

- A term sheet acts as a foundation for achieving mutual agreement between parties, providing a structured framework to align expectations
- Despite its non-binding nature, it plays a pivotal role in shaping the investment process
- The following analysis will outline the steps required to transition from the term sheet to a binding and definitive agreement

1. Financial Due Diligence: Investors conduct due diligence to verify financial, legal, and operational aspects of the startup



2. Drafting Legal Agreements: Key agreements, such as the SPA, SHA, and AoA amendments, are prepared to define the rights, obligations, and structural changes for the investment



3. Negotiation and Legal Review: The drafted agreements undergo thorough negotiations and legal scrutiny to finalize terms that align with both parties' interests



4. Signing and Closing: After the agreements are finalized, documents are signed, funds are transferred, and shares are issued, formalizing the investment



ESCP Alternative
Investment Society