VC Term Sheet Primer

Adapted from www.feld.com blog posts

PRICE

Obviously the first term any entrepreneur is going to look at is the price. The pre-money and post-money terms are pretty easy to understand. The pre-money valuation is what the investor is valuing the company today, before investment, while the post-money valuation is simply the pre-money valuation plus the contemplated aggregate investment amount. There are two items to note within the valuation context: stock option pools and warrants.

Both the company and the investor will want to make sure the company has sufficiently reserved shares of equity to compensate and motivate its workforce. The bigger the pool the better, right? Not so fast. While a large option pool will make it less likely that the company runs out of available options, note that the size of the pool is taken into account in the valuation of the company, thereby effectively lowering the true pre-money valuation. If the investor believes that the option pool of the company should be increased, they will insist that such increase happen prior to the financing. Don't bother to try to fight this, as nearly all VCs will operate this way. It is better to just negotiate a higher pre-money valuation if the actual value gives you heartburn. Standard language looks like this:

Amount of Financing: An aggregate of $ X million, representing a __% ownership position on a fully diluted basis, including shares reserved for any employee option pool. Prior to the Closing, the Company will reserve shares of its Common Stock so that __% of its fully diluted capital stock following the issuance of its Series A Preferred is available for future issuances to directors, officers, employees and consultants.

Alternatively:

Price: $______ per share (the Original Purchase Price). The Original Purchase Price represents a fully-diluted pre-money valuation of $ __ million and a fully-diluted post money valuation of $__ million. For purposes of the above calculation and any other reference to fully-diluted in this term sheet, fully-diluted assumes the conversion of all outstanding preferred stockof the Company, the exercise of all authorized and currently existing stock options and warrants of the Company, and the increase of the Companys existing option pool by [ ] shares prior to this financing.

Recently, another term that has gained popularity among investors is warrants associated with financings. As with the stock option allocation, this is another way to back door a lower valuation for the company. Warrants as part of a venture financing – especially in an early stage investment – tend to create a lot of unnecessary complexity and accounting headaches down the road. If the issue is simply one of price, we recommend the entrepreneur negotiate for a lower pre-money valuation to try to eliminate the warrants. Occassionally, this may be at cross-purposes with existing investors who – for some reason – want to artificially inflate the valuation since the warrant value is rarely calculated as part of the valuation (but definitely impacts the future allocation of proceeds in a liquidity event.) Note, that with bridge loan financings, warrants are commonplace as the bridge investor wants to get a lower price on the conversion of their bridge into the next round – it's not worth fighting these warrants. The best way for an entrepreneur to negotiate price is to have multiple VCs interested in investing in his company – (economics 101: If you have more demand (VCs interested) than supply (equity in your company to sell) then price will increase.) In early rounds, your new investors will likely be looking for the lowest possible price that still leaves enough equity in the founders and employees hands. In later rounds, your existing investors will often argue for the highest price for new investors in order to limit the existing investors dilution. If there are no new investors interested in investing in your company, your existing investors will often argue for an equal to (flat round) or lower than (down round) price then the previous round. Finally, new investors will always argue for the lowest price they think will enable them to get a financing done, given the appetite (or lack thereof) of the existing investors in putting more money into the company. As an entrepreneur, you are faced with all of these contradictory motivations in a financing, reinforcing the truism that it is incredibly important to pick your early investors wisely, as they can materially help or hurt this process.

Pre-money/Post-money

In a venture capital investment, the terminology and mathematics can seem confusing at first, particularly given that the investors are able to calculate the relevant numbers in their heads. The concepts are actually not complicated, and with a few simple algebraic tips you will be able to do the math in your head as well, leading to more effective negotiation.

The essence of a venture capital transaction is that the investor puts cash in the company in return for newly-issued shares in the company. The state of affairs immediately prior to the transaction is referred to as "pre-money," and immediately after the transaction "post-money."

The value of the whole company before the transaction, called the "pre-money valuation" (and similar to a market capitalization) is just the share price times the number of shares outstanding before the transaction:

Pre-money Valuation = Share Price * Pre-money Shares

The total amount invested is just the share price times the number of shares purchased:

Investment = Share Price * Shares Issued

Unlike when you buy publicly traded shares, however, the shares purchased in a venture capital investment are new shares, leading to a change in the number of shares outstanding:

Post-money Shares = Pre-money Shares + Shares Issued

And because the only immediate effect of the transaction on the value of the company is to increase the amount of cash it has, the valuation after the transaction is just increased by the amount of that cash:

Post-money Valuation = Pre-money Valuation + Investment

The portion of the company owned by the investors after the deal will just be the number of shares they purchased divided by the total shares outstanding:

Fraction Owned = Shares Issued /Post-money Shares

Using some simple algebra (substitute from the earlier equations), we find out that there is another way to view this:

Fraction Owned = Investment / Post-money Valuation = Investment / (Pre-money Valuation + Investment)

So when an investor proposes an investment of $2 million at $3 million "pre" (short for premoney valuation), this means that the investors will own 40% of the company after the transaction:

$2m / ($3m + $2m) = 2/5 = 40%

And if you have 1.5 million shares outstanding prior to the investment, you can calculate the price per share:

Share Price = Pre-money Valuation / Pre-money Shares = $3m / 1.5m = $2.00

As well as the number of shares issued:

Shares Issued = Investment /Share Price = $2m / $2.00 = 1m

The key trick to remember is that share price is easier to calculate with pre-money numbers, and fraction of ownership is easier to calculate with post-money numbers; you switch back and forth by adding or subtracting the amount of the investment. It is also important to note that the share price is the same before and after the deal, which can also be shown with some simple algebraic manipulations.

A few other points to note:

Investors will almost always require that the company set aside additional shares for a stock option plan for employees. Investors will assume and require that these shares are set aside prior to the investment, thus diluting the founders.

If there are multiple investors, they must be treated as one in the calculations above. To determine an individual ownership fraction, divide the individual investment by the post-money valuation for the entire deal.

For a subsequent financing, to keep the share price flat the pre-money valuation of the new investment must be the same as the post-money valuation of the prior investment.

For early-stage companies, venture investors are normally interested in owning a particular fraction of the company for an appropriate investment. The valuation is actually a derived number and does not really mean anything about what the business is "worth."

LIQUIDATION PREFERENCE

The liquidation preference determines how the pie is shared on a liquidity event. There are two components that make up what most people call the liquidation preference: the actual preference and participation. To be accurate, the term liquidation preference should only pertain to money returned to a particular series of the company's stock ahead of other series of stock. Consider for instance the following language:

Liquidation Preference: In the event of any liquidation or winding up of the Company, the holders of the Series A Preferred shall be entitled to receive in preference to the holders of the Common Stock a per share amount equal to [x] the Original Purchase Price plus any declared but unpaid dividends (the Liquidation Preference).

This is the actual preference. In the language above, a certain multiple of the original investment per share is returned to the investor before the common stock receives any consideration. For many years, a “1x” liquidation preference was the standard. Starting in 2001, investors often increased this multiple, sometimes as high as 10x! (Note, that it is mostly back to 1x today.)

The next thing to consider is whether or not the investor shares are participating. Again, note that many people consider the term “liquidation preference” to refer to both the preference and the participation, if any. There are three varieties of participation: full participation, capped participation and non-participating.

Fully participating stock will share in the liquidation proceeds on a pro rata basis with common after payment of the liquidation preference. The provision normally looks like this:

Participation: After the payment of the Liquidation Preference to the holders of the Series A Preferred, the remaining assets shall be distributed ratably to the holders of the Common Stock and the Series A Preferred on a common equivalent basis.

Capped participation indicates that the stock will share in the liquidation proceeds on a pro rata basis until a certain multiple return is reached. Sample language is below.

Participation: After the payment of the Liquidation Preference to the holders of the Series A Preferred, the remaining assets shall be distributed ratably to the holders of the Common Stock and the Series A Preferred on a common equivalent basis; provided that the holders of Series A Preferred will stop participating once they have received a total liquidation amount per share equal to [X] times the Original Purchase Price, plus any declared but unpaid dividends. Thereafter, the remaining assets shall be distributed ratably to the holders of the Common Stock.

One interesting thing to note in the section is the actually meaning of the multiple of the Original Purchase Price (the [X]). If the participation multiple is 3 (three times the Original Purchase Price), it would mean that the preferred would stop participation (on a per share basis) once 300% of its original purchase price was returned including any amounts paid out on the liquidation preference. This is not an additional 3x return, rather an addition 2x, assuming the liquidation preference were a 1 times money back return. Perhaps because of this correlation with the actual preference, the term liquidation preference has come to include both the preference and participation terms. If the series is not participating, it will not have a paragraph that looks like the ones above.

Liquidation preferences are usually easy to understand and assess when dealing with a series A term sheet. It gets much more complicated to understand what is going on as a company matures and sells additional series of equity as understanding how liquidation preferences work between the series is often mathematically (and structurally) challenging. As with many VC-related issues, the approach to liquidation preferences among multiple series of stock varies (and is often overly complex for no apparent reason.) There are two primary approaches: (1) The follow-on investors will stack their preferences on top of each other: series B gets its preference first, then series A or (2) The series are equivalent in status (called pari passu – one of the few latin terms lawyers understand) so that series A and B share pro-ratably until the preferences are returned. Determining which approach to use is a black art which is influenced by the relative negotiating power of the investors involved, ability of the company to go elsewhere for additional financing, economic dynamics of the existing capital structure, and the phase of the moon.

Most professional, reasonable investors will not want to gouge a company with excessive liquidation preferences. The greater the liquidation preference ahead of management and employees, the lower the potential value of the management / employee equity. There's a fine balance here and each case is situation specific, but a rational investor will want a combination of "the best price" while insuring "maximum motivation" of management and employees. Obviously what happens in the end is a negotiation and depends on the stage of the company, bargaining strength, and existing capital structure, but in general most companies and their investors will reach a reasonable compromise regarding these provisions. Note that investors get either the liquidation preference and participation amounts (if any) or what they would get on a fully converted common holding, at their election; they do not get both (although in the fully participating case, the participation amount is equal to the fully converted common holding amount.)

Since we've been talking about liquidation preferences, it's important to define what a "liquidation" event is. Often, entrepreneurs think of a liquidation as simply a "bad" event – such as a bankruptcy or a wind down. In VC-speak, a liquidation is actually tied to a "liquidity event" where the shareholders receive proceeds for their equity in a company, including mergers, acquisitions, or a change of control of the company. As a result, the liquidation preference section determines allocation of proceeds in both good times and bad. Standard language looks like this:

A merger, acquisition, sale of voting control or sale of substantially all of the assets of the Company in which the shareholders of the Company do not own a majority of the outstanding shares of the surviving corporation shall be deemed to be a liquidation.

Ironically, lawyers don't necessary agree on a standard definition of the phrase "liquidity event." Jason once had an entertaining (and unenjoyable) debate during a guest lecture he gave at his alma mater law school with a partner from a major Chicago law firm (who was teaching a venture class that semester) that claimed an initial public offering should be considered a liquidation event. His theory was that an IPO was the same as a merger, that the company was going away, and thus the investors should get their proceeds. Even if such a theory would be accepted by an investment banker who would be willing to take the company public (no chance in our opinion), it makes no sense as an IPO is simply another funding event for the company, not a liquidation of the company. However, in most IPO scenarios, the VCs "preferred stock" is converted to common stock as part of the IPO, eliminating the issue around a liquidity event in the first place.

BOARD OF DIRECTORS

VCs care about control provisions in order to keep an eye on their investment as well as – in some cases – comply with certain federal tax statutes that are a result of the types of investors that invest in VC funds. One of the key control mechanisms is the election of the board of directors.

There is no secret science in the board of director election paragraph – it simply spells out how the board of directors will be chosen. The entrepreneur should think carefully about what they believe the the proper balance should be between investor, company, founder and outsider represenation should be on the board. There are many existing VC (and entrepreneur) posts concerning the value of a board, the desired composition of the board, and what a board is responsible for. This post doesn't delve into those issues – we are simply addressing how the board is selected.

A typical term sheet looks as follows:

Board of Directors: The size of the Company's Board of Directors shall be set at [n]. The Board shall initially be comprised of ____________, as the Investor representative[s] _______________, _________________, and ______________. At each meeting for the election of directors, the holders of the Series A Preferred, voting as a separate class, shall be entitled to elect [x] member[s] of the Company's Board of Directors which director shall be designated by Investor, the holders of Common Stock, voting as a separate class, shall be entitled to elect [x] member[s], and the remaining directors will be [Option 1: mutually agreed upon by the Common and Preferred, voting together as a single class.] [or Option 2: chosen by the mutual consent of the Board of Directors].

If a subset of the board is being chosen by more than one constituency (e.g., two directors chosen by the investors, two by founders / common holders and one by "mutual consent"), you should consider what is best: (a) chosen my mutual consent of the board (one person, one vote) or (b) voted upon on the basis of proportional share ownership on a common-as-converted basis.

VCs will often want to include a board observer as part of the agreement either instead of or in addition to an official member of the board. This is typical and usually helpful, as many VC partners have an associate that works with them on their companies. While there's rarely any contention about who attends a board meeting, most VCs will want the right to have another person from the firm at the board meeting, even if they are non-voting (an "observer").

Many investors will mandate that one of the common-stockholder chosen board members be the then-serving CEO of the company. This can be tricky if the CEO is the same as one of the key founders – often you'll see language giving the right to a board seat to one of the founders and a separate board seat to the then CEO – consuming two of the common board seats. Then – if the CEO changes, so does that board seat.

While it is appropriate for board member and observers to be reimbursed for their reasonable out-of-pocket costs for attending board meetings, we rarely see board members receive cash compensation for serving on the board of a private company. Outside board members are usually compensated with stock options – just like key employees – and are often invited to invest money in the company alongside the VCs.