Driving Business Advantage

Understanding Term Sheets and Valuations

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What is a term sheet?

- aka- “Letter of Intent,” “Memorandum of Understanding,” “Agreement in Principle”
- Basic agreement on the material terms of the transaction
  - Road map, marching orders
- More detail is generally better (especially for the company/seller)

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Non Binding (But…..)

- A term sheet is for the most part not a binding agreement
  - Subject to actual documents being negotiated
  - Subject to due diligence
  - Subject to other closing conditions (legal opinion, etc.)
  - ***Timeline from Term Sheet to closing has been much longer and much more uncertain in the last few years***
- Confidentiality ("No Shop")
  - No disclosure of terms (and even existence) of the term sheet
- Exclusivity
  - Investor has some period of exclusivity (45 to 90 days)
- If you really want to mess up your transaction, this is the place to do it

Pre-Money Valuation

- "Pre-Money Valuation" = value of the company before the new money is invested
  - Helps calculate price per share, and % of the company being sold

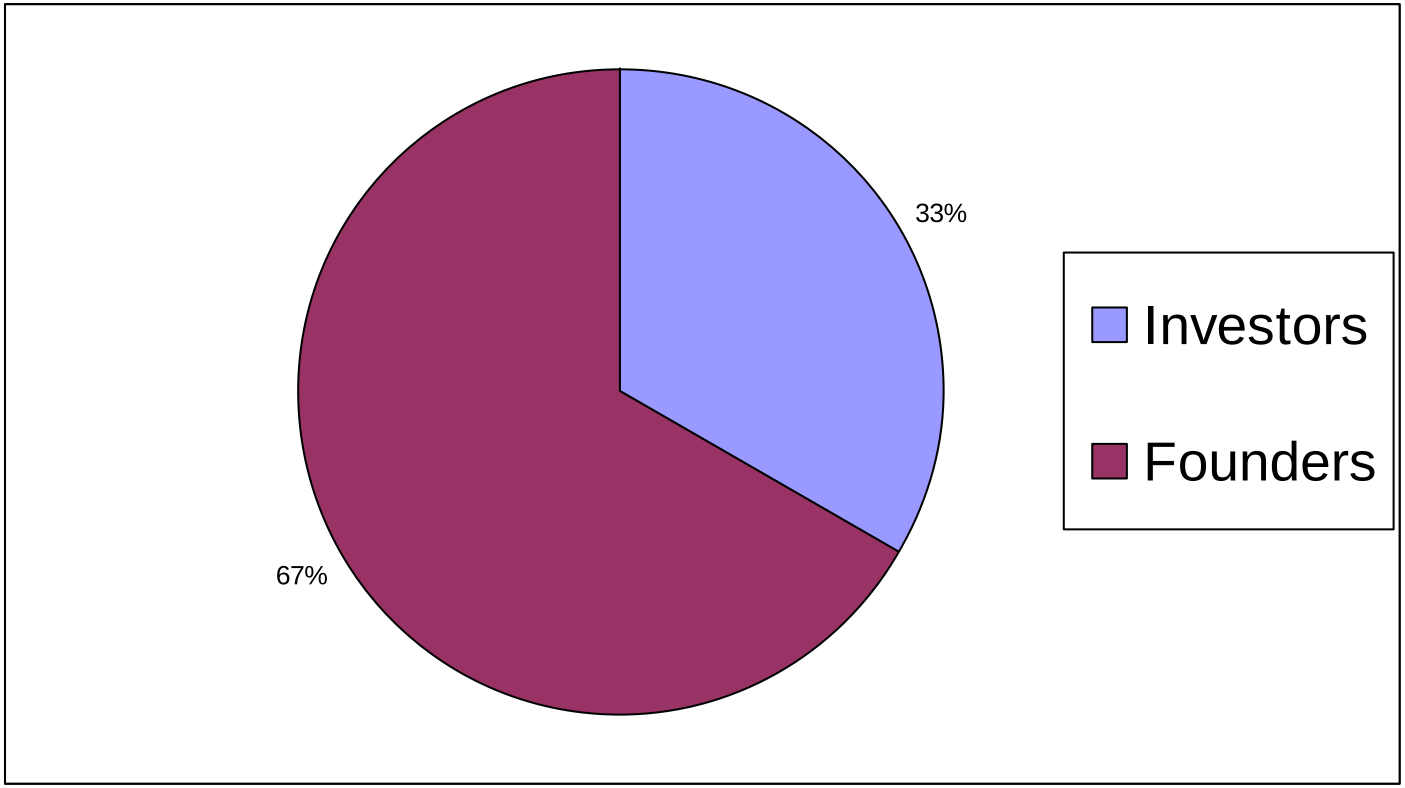
Share Price = *<u>Pre-Money Valuation</u>*

Pre-money Shares Outstanding

- Critical Issue –What shares are counted as "Outstanding"?
  - All outstanding options?
  - All options reserved for issuance under the option pool?
  - Note: The higher this number, the lower the share price, and the higher the number of shares issued for the same amount invested

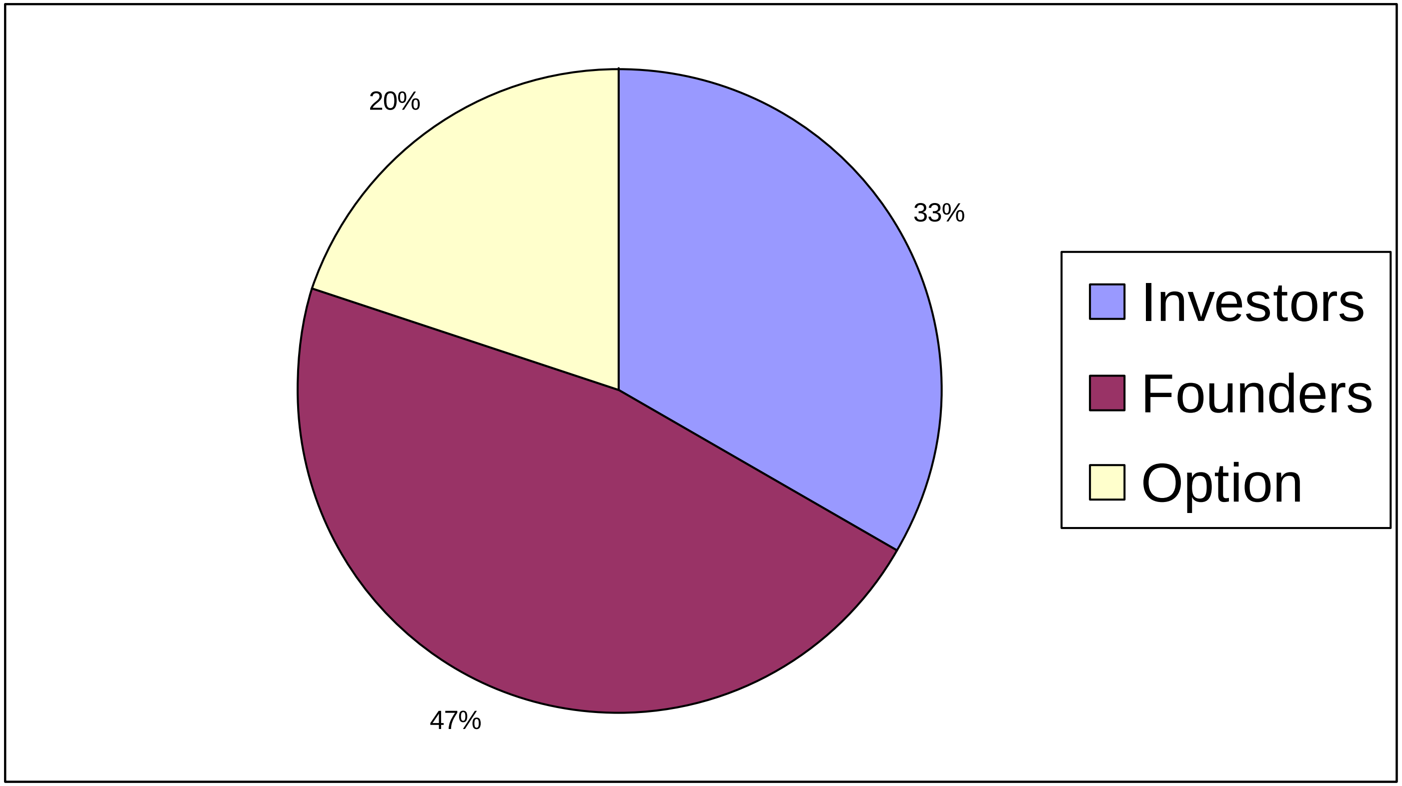
Key Terms – Pre Money Valuation

- Pre Money Valuation (Without Option Pool)



Key Terms – Pre Money Valuation

- Pre Money Valuation (With Option Pool)



CAUTION!

- Pre-Money Valuation is only one of many economic terms.

“You can name the valuation, if I can name all the other terms.”

- Angel / VC Investor

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Convertible Preferred Stock

- Why Convertible Preferred Stock?
  - “Convertible” - All of the upside of common stock
  - “Preferred” - Preference over common stock on dividends, distributions, liquidation, redemption

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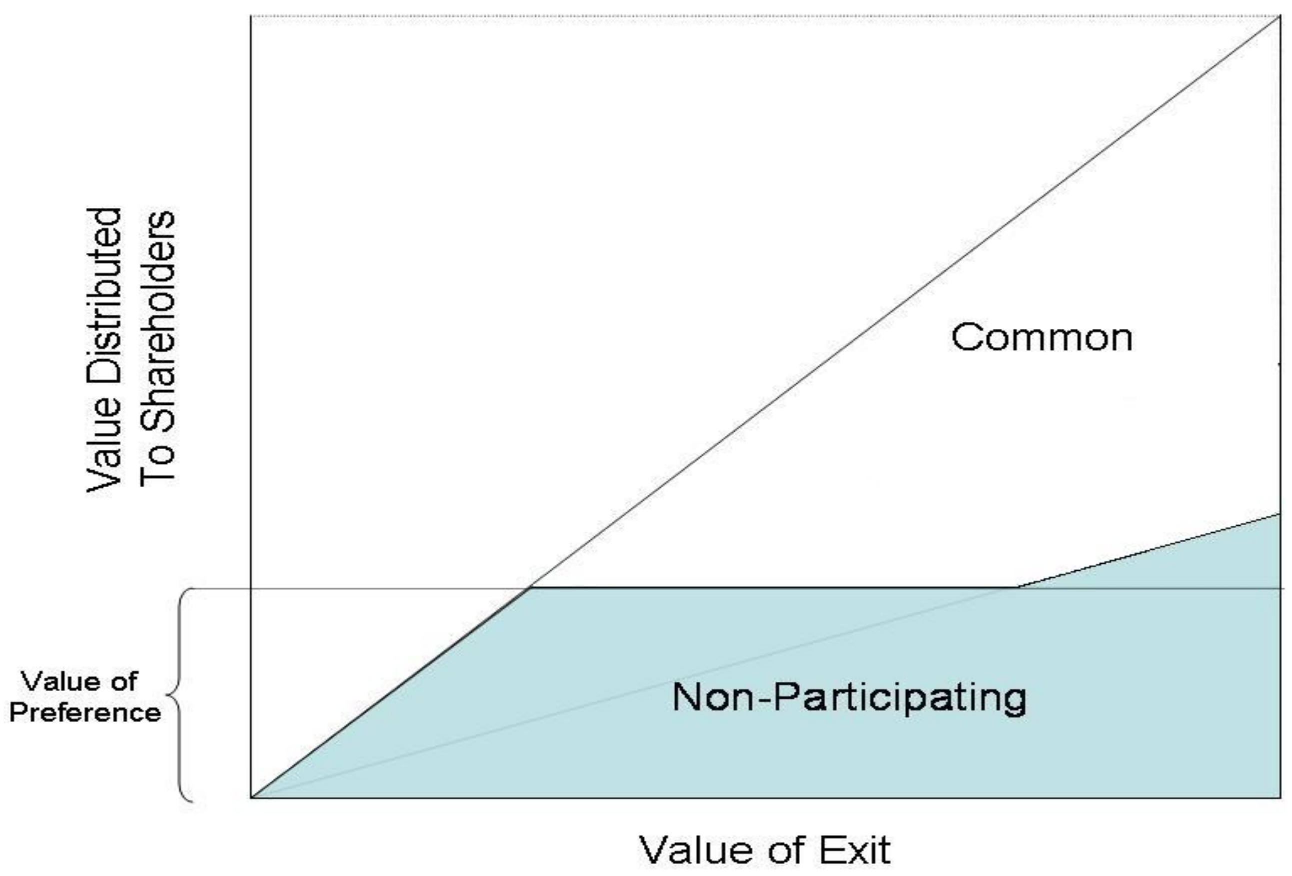
Liquidation Preference

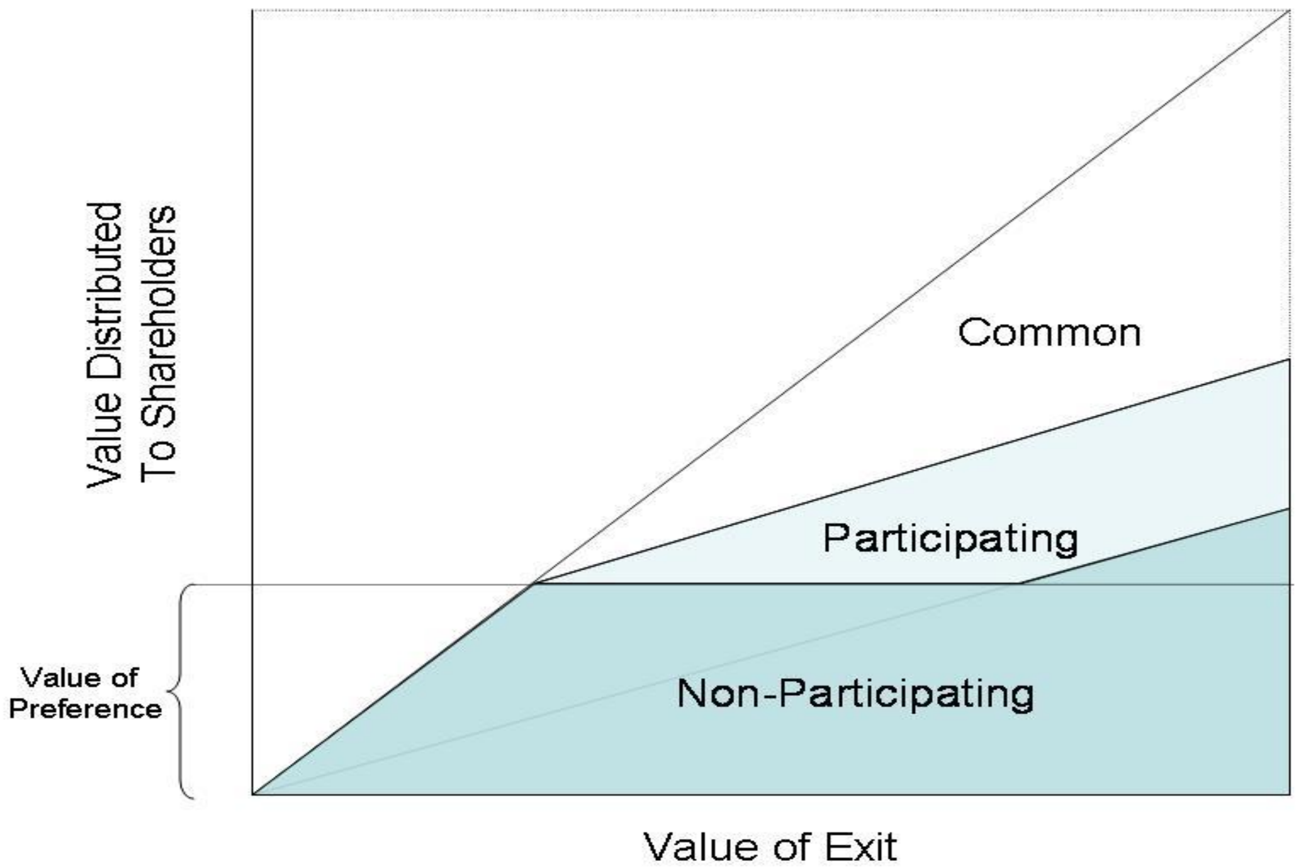
- Applies when a "liquidation event" occurs (usually M&A)
- When distributing liquidation proceeds, preferred have right to get their money back (and perhaps more) before the common get anything.
- Sometimes "multiples" are used (1x, 2x, 3x the investment amount). Sometimes accruing dividends are included.
- "Preference overhang" is the total amount of proceeds due to the preferred stock – can make the common stock virtually worthless.
- Three main flavors:
  - Non-participating
  - Participating preferred (without cap)
  - Participating preferred (with a cap)

Non-Participating Preferred



Source: www.wikipedia.org

Participating Preferred



Source: www.wikipedia.org

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Current Trends (Q1/10 – Q4/10)

- For Series A financings, ***28-50% had some form of participating preferred.***
- For Series B+ financings, ***55-72% had some form of participating preferred.***
- Source: Foley Hoag's Perspectives – December 2010

Antidilution Protection

- All preferred stock converts to common stock at a certain ratio, usually starting at 1-for-1.
- Anti-dilution protection changes the conversion ratio, resulting in the preferred getting more shares of common upon conversion
- Addresses Investors' concern re: valuation
- Protect investors in a "down round" - when new money comes in at a pre-money valuation (or price per share) that is lower than the previous round's post-money valuation.

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Weighted Average

- Takes into account the proportional relevance (or weight) of each component in the calculation rather than treating each component similarly.
- Result - the conversion ratio based on the average of the price at which the company sold the new stock, valuing the common stock outstanding at the pre-adjusted conversion price.
- Sometimes formulated as “broad-based” and sometimes as “narrowly-based” (“narrowly-based” is more favorable to the protected preferred stock.)
- More typical, and much less onerous to un-protected stockholders, than full ratchet.

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Full Ratchet

- The conversion ratio of the protected preferred stock is “ratcheted down” to the lowest price at which securities are sold in the down-round.
- This applies even if only one share is sold! Treats all down-rounds the same, irrespective of number of shares actually issued.
- Very onerous, and not the standard approach.
- Usually seen in company’s without bargaining leverage, in distress, or with a history of down rounds.

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Current Trends (Q1/10 – Q4/10)

- For Series A financings, ***8% had full ratchet; remainder were evenly split between narrowly based and broadly based weighted average.***

- For Series B+ financings, ***18% had full ratchet.***

- Source: Foley Hoag's Perspectives – December 2010

Other Key Terms for Company

- Dividends
- Redemption
- Voting Rights
  - Board Seats
  - “Protective Provisions”
- Pre-emptive rights
- Information rights
- Registration rights
- Legal fees / Drafting control

Other Key Terms for Founders

- Reverse Vesting
- Non-competition and Non-solicitation Agreements
- Non-Disclosures and IP Development Agreements
- Right of first refusal
- Drag along rights / Tag along rights

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Final Thoughts

- Focus on what's in the best interest of the company.
- Always ask "why" when terms are proposed.
- All money is not the same. Choose your investors wisely – their belief in YOU is a not an option, it's a necessity.

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Other Resources

- www.emergingenterprisecenter.com:
  - Glossary (commonly used terms)
  - Ask the Startup Lawyers (common questions and answers; submit your questions!)
  - EEC Perspectives (our quarterly publication tracking terms of New England VC deals)
- NVCA Model Venture Capital Financing Documents (including model term sheet):
  - www.nvca.org (click “Resources” then “Model Legal Documents”) or use http://bit.ly/bj7Pn
  - Forms are intended as starting point only

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Questions?

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