TEN CAPITAL NETWORK

TERMS SHEETS

eGuide

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NEGOTIATING

The Terms Sheet

When it comes to negotiating a terms sheet, there are several key elements to keep in mind. Here are a few things you should consider:

1. Valuation is the biggest hurdle because it sets equity ownership.

Key terms that often come into play include the following:

1. Liquidation preferences

If the investors feel the pre-money valuation is too high, they may ask for a 1x or 2x liquidation preference.

2. Investing founders share

Investors want to know the team will remain in place for the first few years. They will likely require them to re-earn their shares.

3. Redemption rights

If the business goes in a direction that the investors are not comfortable with then some investors may prepare for an early exit.

Consider convertible debt for an initial terms sheet and move to equity when you find the right lead investor. Keep in mind that there are many investors who want to be in the deal but aren't willing to do the work for leading the round. This means that you will need to look for a lead investor. The criteria for a lead investor is an interest in equity and a willingness to invest more than $100K. This will generate enough motivation to properly develop the terms sheet.

Negotiating the Terms

In negotiating the terms of a startup investment, the investor should develop a standard terms sheet and modify it for each deal.

When starting due diligence be sure to send the terms sheet to the startup for their review. In some cases, they may be unfamiliar with terms sheets and will need time to study and understand it.

The key elements to consider in negotiating terms are as follows:

- Valuation

Valuation is the most critical term to negotiate because it has the biggest impact on returns.

- Vesting founders shares

It's important to unvest founders' shares and have them revest over a few years. If the founder leaves early, there are shares to compensate for the replacement.

- Option pool

Set up to offer options to the employees. If you don't have an option pool, then you have to provide all compensation out of cash which is not an ideal way to run a business.

- Board of directors

Set up a board with proper governance.

- Liquidation preference

Consider including a liquidation preference to set a floor on your return.

- Growth strategy

Gain consensus with the team and the investors on the growth strategy. Figure out if you're hitting the gas and going for the moon or growing the business carefully.

USING CONVERTIBLE NOTES WISELY & THE PROS AND CONS

When launching a fundraise, you should always be in a position to take funding. There are usually investors who want to join the deal but don't have an interest in taking on a lead investor role. For this reason, a convertible note works well in this stage of the raise because it is a debt instrument that converts to equity later, so there is no valuation to negotiate.

Here are some things to know about convertible notes:

1. Startups can accept investors into the deal with relative ease, given most notes have simple terms, rights, and conditions.
2. The note is on a rolling close. This means that the investor signs the check, the startup signs the note, and the funding goes into the business the next day.
3. You can use the note over several smaller fundraises to gather investor funds.
4. When setting up a convertible note, consider what will happen upon conversion to the cap table.
5. Startups should take care not to raise too much funding off convertible notes.
6. In later stages, investors are going to want a certain amount of ownership in the deal. If there is too much convertible debt, then it will be difficult to give the investor the ownership they want.

While convertible notes can be very useful, remember that there are pros and cons to using convertible notes.

- Startups use convertible notes primarily for seed rounds and bridge rounds.
- They are lower in cost because the documents are simpler than equity terms sheets.
- Convertible notes avoid setting a price, so they are easier to negotiate.
- A convertible note keeps the cap table simple as they start in debt form and convert to equity later.
- The downside to convertible notes is that they have few protective provisions found in equity terms sheets such as board seats.
- Valuation is not fixed which means a later priced round will set it and there's little control the investor has over it.
- There are no tax benefits for a Qualified Small Business 1202 which applies only to equity investments.

Convertible notes are useful for launching a seed fundraise or even a Series A because it lets the startup capture interest in the deal while searching for the lead investor. An equity round should be done to set the valuation and provide tax benefits/protective provisions for the investor.

KEY TERMS & FOUNDER FRIENDLY TERMS

Key Terms

Not everyone is familiar with terms sheets, however if you start with an understanding of some key terms you'll be better able to navigate a terms sheet. Here are some financial parameters to look for in a terms sheet:

- Type of Security

1. Convertible Preferred Stock
2. Series A Convertible Preferred Stock
3. Series Seed Preferred Stock

- Investment Amount

This is how much is being raised.

- Pre-Money Valuation

This is what the business is worth before the investment. The pre-money valuation can also appear in the **Price Per Share** section.

- Price Per Share

The price per share is calculated by dividing the agreed on pre-money valuation by the total number of shares outstanding in the startup. The share price calculation is where the term **fully diluted** shares outstanding

comes into play. The term **fully diluted** means the options pool and other forms of stock, such as warrants, must be included in the share total.

- Conversion

Conversion refers to the rate preferred shares can be converted to common.

- Dividends

These are either **Cumulative Dividends** or **Non-Cumulative Dividends**. This determines if dividends are paid out along the way or at conversion.

Founder Friendly Terms

The term sheet provides terms in favor of the founder over the investor or vice versa.

In a founder friendly terms sheet:

1. There is no expiration date on the investment offer.
2. The option pool comes out of both the investors portion as well as the founders portion.
3. There is no confidentiality agreement. The founders are free to talk about the deal.
4. There is no liquidation preference for the investors.
5. The startup does not pay investors legal fees.

HOW TO PAPER THE FUNDRAISE AND LIQUIDATION PREFERENCE

Paper the Fundraise

After diligence, investors who want to move forward will sign all of the necessary investment documents.

For a convertible note raise, the investor and CEO will sign the note. It’s a rolling close, so this means that the funds go into the business the next day.

For an equity raise, there are several documents in addition to the terms sheet.

Some Series A raises can contain up to 9 separate documents including a subscription agreement, an option pool agreement and investor accreditation status.

If the investors requested a minimum amount of funding before closing, then the investor funds will go into an escrow account until the minimum threshold is reached.

Some companies have the investors sign the documents before due diligence in which case the funding is contingent on passing that due diligence phase.

Liquidation Preference

Liquidation preference is a right commonly found in terms sheets.

It provides the investor the right to receive their investment back and then the remaining profits are distributed to other stakeholders.

It's often expressed in multiples such as 1x or 2x. This means the investors with those rights will receive 1x their investment before distributing the remaining exit funds based on their equity-based division.

Liquidation preferences come in three forms.

1. Participating preferred

This means they get their liquidation preference and share in the equity pro rata with the other investors.

2. Non-participating preferred

In this case, they get their liquidation preference but do not share in the equity pro rata with the other investors.

3. Participating preferred with a cap

Here, they get their liquidation preference and share in the equity pro rata with the other investors up to a Cap.

Investors often use this to compensate for what they consider to be a high pre-money valuation.

ANTI-DILUTION & WARRANTS

Anti-Dilution

Terms sheets use Anti-Dilution clauses to protect the investors.

Anti-Dilution becomes important during down rounds in which the founders raise funding at a lower valuation than a previous round.

There are three scenarios in this case:

1. No Anti-Dilution Protection

This means that investors and founders share in dilution from any follow-on rounds' funding.

2. Full Ratchet Anti-Dilution

With full ratchet, the investor's share price is adjusted all the way down to the level needed so that two things happen:

- The new investor gets their percentage.
- The current preferred-share investor with full ratchet anti-dilution protection maintains their ownership percentage in the startup.

A full-ratchet scenario dilutes founders' ownership dramatically, so this method is typically unfavorable to founders.

3. Weighted Average Anti-Dilution

The Weighted Average Method takes into account the total number of shares outstanding. The more shares owned by an investor, the less dilution they receive.

This method is usually favored by founders. In this case, founders get diluted, but not as much as in a full-ratchet scenario. Preferred-share investors get diluted by some, as opposed to not at all in a full-ratchet scenario.

Warrants

You may come across the term **warrants** in a terms sheet.

Warrants are a type of security that gives investors the option to buy more stock over a designated time frame at a specific price.

Three parameters define the details of a typical warrant clause:

- Term
- Coverage
- Price

1. The **term** sets the window of time the investor has the option to exercise the warrant.

2. **Coverage** sets the number of shares the investor is entitled to buy.

3. **Price** sets the price at which an investor can purchase the shares. This is typically the same as the current price.

Warrants are used to *sweeten* the deal by enabling an investor to buy more shares later.

BOARD RIGHTS & INFORMATION RIGHTS

Board Rights

The terms sheet works to set out the board's composition.

For an early-stage company, the board is comprised of:

Three (3) individuals with one (1) representative being the CEO of the Company, one (1) representative being the Lead Investor or his designee (the Series A Director), and one (1) representative being an individual mutually agreed upon by the Lead Investor and the CEO of the Company.

For a growth-stage company, the board typically consists of 5 persons:

- 2 chosen by the company
- 2 chosen by the investors
- A fifth person from the industry who provides domain knowledge

For some investors, there's also a board observer member named by the preferred-share investor who attends the board meetings. The board observer can ask limited questions but does not have a vote in any board decisions.

Information Rights

The terms sheet also sets out the Information Rights for the investors, similar to Board Rights.

The **Information Rights** section defines what information and reports are required, the reporting schedule, and sometimes which investors are entitled to receive the information.

The standard set of financial reports that investors require include:

- Profit and loss (P&L) statements
- Balance sheets
- Cash flow statements

For early-stage companies, these are typically unaudited financials.

For a startup that is up and running, founders should recast the business plan as an operating plan that clearly outlines the key milestones the team intends to achieve. Typical milestones for a growing startup include sales goals, new product introductions, new customer segment plans, and team expansion.

In most cases, reports are provided quarterly.

It's a benefit to founders to limit the number of investors who will receive reports and financials. Many startups have sensitive or proprietary information, so it makes sense to keep the distribution list small.

PARI PASSU & PAY TO PLAY

Pari Passu

The terms sheet sets out terms such as:

- Pari Passu
- Last Money in Rules
- Exclusivity
- Confidentiality
- Conditions of Financing

Pari passu is a Latin phrase meaning ***equal footing and without preference***. This clause states that if the startup issues any new classes of stock then it shall have equal rights with prior classes. This applies to:

- Liquidation preferences
- Voting rights

The term prohibits the founders from creating a new class of stock that puts existing investors second in line.

The **Last Money In Rules** term states that whoever puts in the most recent funding calls all the shots.

The **Exclusivity** term seeks to prevent the founders from engaging other investors for some period of time. A 30-day duration is typical in this case.

Tied closely to the idea of exclusivity is the **Confidentiality** clause. The reason for this clause is because the investors do not want the founders to reveal any deal terms or other information to competing investors.

Conditions of Financing terms require founders to formalize items such as employment and non-compete agreements with the startup, legal

assignment of all inventions, and other intellectual property to the startup entity.

Pay to Play

A **Pay to Play** clause is intended to create an incentive for existing preferred share investors to invest on a pro-rata basis in future financing rounds.

The clause states that if the existing investors choose not to participate in future rounds, they will lose some or all of their preferential rights.

For example, if a preferred investor in a down round chooses to invest, then that investor maintains his anti-dilution rights. If the investor chooses *not to invest*, then they lose those rights.

Other disincentives for not participating include:

1. Losing some preferred rights.
2. Losing all preferred rights and protections such as forcing the investor into common stock.

DRAG-ALONG RIGHTS/PROTECTIVE PROVISIONS & GOVERNANCE/CONTROL TERMS

Drag-Along Rights/Protective Provisions

The terms sheet will set out Drag-Along Rights and Protective Provisions.

Drag-Along Rights give the investor the right to force the shareholders (founders and others) to sell the startup. Drag-Along Rights are typically most common in VC deals.

Protective Provisions state that if the founders want to take any action that might affect preferred shareholders' investments, the founders have to inform the preferred shareholders and get their collective approval first.

Below is a list of common protective provisions that may be found:

- Merge, sell, or liquidate the company, or any transaction that results in a change of control of the company.
- Change the capitalization structure of the company.
- Issue stock senior to/equal to the stock held by the preferred share investor(s).
- Change the certificate of incorporation or bylaws.
- Change the composition or size of the board of directors.

- Pay or declare dividends.
- Take on a debt obligation such as a loan.

Governance/Control Terms

The terms sheet also contains several investor rights relating to Governance and Control. The 3 most common are:

- **Right of First Refusal**

The Right of First Refusal clause states that if a founder sells his or her shares, then the preferred share investor has the right to buy those founder shares first. Doing so results in increasing the investor's equity ownership in the company.

- **Participation Rights**

This clause says that if the startup company sells shares to raise more funding, the current investors have the right to buy the shares first.

- **Registration Rights**

If the startup registers its stock on the public markets, then the startup must also register the investor stock shares and pay the legal fees for it.

SOURCES OF TERMS SHEETS & KEY TERMS TO FOCUS ON

Sources of Terms Sheets

Startup fundraising requires investment documents and lots of them. While you should seek counsel with your startup-friendly attorney before committing to an equity fundraise, below are several sources of terms sheets you can find on the web in order to familiarize yourself with the documents.

1. **Ycombinator** provides a set of terms sheets for SAFE documents used in seed raises.
2. The NVCA (National Venture Capital Association) provides a set of model legal documents that include terms sheets.
3. Cooley provides the **Series Seed** set of documents on its website.

There are also many online sources for convertible notes. Just spend a little time searching the web and you'll be able to find a wide range of options.

You can also find additional information on the Investor Connect Resources page located here.

Key Terms to Focus On

There are over 125 terms in the NVCA glossary for terms sheets. There's no doubt that there is a lot to remember and it can take some time to familiarize yourself with all of the terms.

In order to get a headstart on understanding terms sheets, here are 6 terms you should remember for your startup investment:

1. **Valuation,** or the price you pay for the equity, is the most important term that impacts the return to the investor.
2. **Participation Rights** define the investors' right to invest in future rounds. Most startup investors invest a smaller amount at the seed level and invest larger amounts at the Series A stage. It's important to maintain your position in a successful startup.
3. **Board and Information Rights** give the investors a voice in the company and in what information they can expect to receive.
4. **Liquidation Preference** pays back the holding investor first and then the remaining funds are allocated to the investors based on their ownership percentage. This sets a floor on the investors return.
5. **Redemption Rights** gives the investors the right to sell their shares back to the company if they want to exit before an acquisition.
6. **Unvesting Founders Shares** requires the founders to revest some of their shares. This provides equity to compensate the founder's replacement in the event the founder leaves early.

THE SOFT SIDE OF VALUATIONS & DEALBREAKERS

The Soft Side of Valuations

In setting the valuation for a startup there are financial factors and then there are non-financial factors. The non-financial factors are the soft side of valuations.

The soft side includes:

1. **Current market conditions**

As the market heats up certain sectors turn *hot*. If a market turns hot then it will command a higher valuation than the numbers indicate.

2. **Predictability**

Companies with recurring revenue streams and long term contracts command a higher valuation because their revenue is much more predictable.

3. **Customer concentration**

Startups with a broader list of customers will survive longer. If a customer accounts for over half of the business then this should be reflected in the valuation.

4. **Pre-profitability**

For early stage companies, those with profitability should command a higher valuation.

5. **Pre-revenue**

For early stage businesses without revenue, intellectual property and customer forecasts are important.

Dealbreakers

During the deal process there is always something that gives the investor cause to rethink pursuing the investment.

Here is a short list of dealbreakers that indicate it's time to break off the deal process:

1. There are major surprises such as finding out the company has significant debt they did not disclose previously.
2. There are major holes such as finding out a team member is not signing up to work on the project as previously mentioned.
3. There are integrity issues such as a mismatch between what the founder tells you and what is actually there.
4. There is a significant change to the potential of the business such as finding out the market is not as large as previously considered.
5. There is an inability to come to terms because both sides are too far apart.

TERMS AFFECTING THE RETURNS & USING TERMS SHEETS TO MITIGATE THE RISK

Terms Affecting the Returns

There are many terms in a standard terms sheet for investing in a startup; however there are roughly 6 terms that have a direct impact on the return the investor receives.

1. **Pre-Money Valuation**

This is the biggest factor in determining the investor's return. This is often the term receiving the most attention in negotiations.

2. **Liquidation Preference**

Liquidation preference is increasingly being used to protect early investors as it gives them a return first before other investors.

3. **Options Pool**

This is a key consideration with regards to who pays for it. A founder-friendly terms sheet has the investors paying for it, while an investor-friendly terms sheet has the founders paying for it.

4. **Protective Provisions**

This includes electing board members who can influence operational decisions such as approving future fundraising rounds.

5. **Co-Sale Rights and Drag-Along Rights**

These give the investor options for exiting early.

6. **Dividends**

This is not common in early-stage fundings; however, it is a source of returns to the investors in long-term holdings.

Using Terms Sheets to Mitigate the Risk

For every risk in the startup, there is a term to place in the terms sheet to mitigate that risk. Below are some things to consider in order to mitigate risks.

1. If you feel the **valuation is too** high then you can add a liquidation preference.
2. If you think **the team needs oversight**, you can add board seats and fill it with advisors who can help.
3. For **maintaining an investor's position** in the deal, there are anti-dilution clauses, right to participate, and right-of-first-refusal terms.
4. For **maintaining oversight over the operations**, there are information right terms, board seats, and founder-vesting terms.
5. For **achieving an exit**, there are drag-along rights, redemption rights, and registration rights.
6. For the **risks in the deal**, engage the terms to mitigate those risks.

About TEN Capital Network

TEN Capital Network provides funding as a service to companies anywhere raising venture capital. Its network of over 11,000 accredited investors represents venture capital, angels, family offices, and high networth individuals.

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