Agreeing on a Term Sheet

- A proposal from investor(s) which outlines how they propose to make an investment.
- A skeleton of the impending contract, which defines a business relationship to be converted to a legal document
- Not legally binding except for exclusivity for a period, typically of 30 to 60 days
- Either party can walk but might be liable for the other parties costs
- There is a state of the art to Term Sheets which evolves as best practices spread by investors, lawyers and inventors

Exclusivity

- Term sheets represent indicative terms for the final agreement. Not legally binding except with respect to exclusivity.
- The exclusivity clause defines the period of time during which the company agrees to talk to ne other investor. A breach of exclusivity can result in a claim fro damages.
- The investors use this time to complete their due diligence, negotiate detailed legal documents and complete the investment.
- With exclusivity control shifts towards the investor:
  - The company must discontinue discussions with others and not start new discussions.
  - Investors are not compelled to complete the investment
  - There is the potential for “deal creep”
  - Future investors will be suspicious of damaged goods
  - The company should seek to minimise the period and ensure as much due diligence is done ahead of time to minimise surprises

Percentage ownership granted to investor

- Investor ownership depends on their invested amount and the valuation of the company
- Premoney valuation is the valuation of the company excluding the invested capital
- Postmoney valuation is the valuation of the company including the capital to be invested
- For example:
  - Investor A offers $2 million for 20% of the company
  - Postmoney is $10 million
  - Premoney is $8 million
  - For 80,000 shares, each share is $100
  - The investor receives 20,000 shares
- One year later: Happiness
  - Investor B offers $4 million for 20% of the company
  - Postmoney is $20 million. Premoney is $16 million. New price per share is $160
  - Investor A has realised an increase in value of 60% (from $100 to $160) in one year
  - Value creation is $6 million
- One year later: Unhappiness
  - Investor B offers $1 million for postmoney of $6 milion,
  - Premoney is $5 million. New price per share is $50
  - Book value impaired by 50%

Stock Options

- Investors normally seek a pool of stock options to retain and motivate key management
- The option pool can be created before or after the investment.
- For example:
  - Investor A wants 20% of the company
  - If a 10% pool of options is created
    - 20% becomes 18% if options are created after investment
    - Otherwise founders are dilutes if options are created before investment
- Founders should seek post investment dilution
  - If rejected the founders could suggest
    - Only enough options are created for foreseeable new employees
    - Additional options post the current round be born future investors

Capitalisation Table

- A capitalisation table identifies the investment, stock position, percentage ownership and impact of options pool for all stakeholders.
- All term sheets should include a Cap Table, since they avoid inconsistencies and ambiguities.

	Initial Stock Position	Initial Ownership	Stock Option Pool Created	Ownership Preinvestment	Series B Stock Issued	Fully Diluted Ownership Postinvestment	Issued Stock Position
Founders/executives							
J. Smith	10,000	16.7%	10,000	14.0%	10,000	10.5%	11.9%
M. Jones	15,000	25.0%	15,000	21.0%	15,000	15.8%	17.9%
A. Davis	15,000	25.0%	15,000	21.0%	15,000	15.8%	17.9%
Investor A	20,000	33.3%	20,000	28.0%	20,000	21.0%	23.9%
Investor B	0	0.0%	0	0.0%	23,810	25.0%	28.4%
Option pool	0	0.0%	11,429	16.0%	11,429	12.0%	0.0%
Total stock	60,000	100.0%	71,429	100.0%	95,238	100.0%	100.0%

Round B premoney valuation of $7.5M; postmoney valuation of $10M

	Amount Invested in Series B Round	Price per Share
Investor A	$0.5M	$25
Investor B	$2.5M	$105

Capitalisation Table

- Options are unissued until exercised
- Share capital can be considered as:
  - Issued (i.e. including unexercised stock)
  - Fully diluted (i.e. considers all stock as if options are exercised)
- In this case the options pool is created after investment A and before investment B:
  - With investment A, dilution is over all shareholders
  - With investment B, investor B avoids dilution, because the options exist premoney

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Investors' aims

- Unlike a public company:
  - There are no regulations to protect shareholders
  - The is no liquid market and shareholders cannot readily sell
- Therefore an investor seeks to:
  - **Maximise upside** in the event of an exit
  - **Skew returns**. Protect investment in the event of underperformance by claiming a larger return than their ownership. Unlike a publically traded company, there is no easy exit.
  - **Disproportionate controls**. Preferred stock with rights over actions that affect the investors ' position (e.g. radical changes in strategy, excessive management remuneration, issuing new stock with unfavourable rights). Force liquidation/sale in case of slow progress
  - **Aligned interests** between the interests of investors and founders
  - If business does well these protections and controls are not required. They become important to the investor when the business does not do well.

Founders’ aims

- **Sufficient capital** to reach a value uplift
- **Protect personal positions** should they be deemed surplus
- In so doing:
  - Give away as little of the value as possible
  - Maintain controls
- Founders need to understand the consequences of the terms that the investor offers in order to protect themselves.