RAISING CAPITAL SEMINAR SERIES

LWBJ® INTELLECTUAL CAPITAL AT WORK

BROWNWINICK LAW

GREATER DES MOINES PARTNERSHIP

DSMUSA DES MOINES, IOWA

DSMpartnership.com

RAISING CAPITAL SEMINAR SERIES
Module 5: The Term Sheet: The Details Matter

April 22, 2021

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TODAY’S PRESENTER

Joe Leo – BrownWinick

Joe Leo is a partner with BrownWinick. Joe practices mainly in the areas of securities law, startup law and corporate transactions. Joe represents many early stage and high growth companies along with five Securities and Exchange Commission publicly registered companies. Joe helps his clients in various aspects of their operations, including organization and planning, restructuring, equity and debt offerings and compliance, and corporate governance matters. In addition, Joe is an adjunct professor of Securities Law at Drake University Law School.

A JOINT COLLABORATION

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WELCOME

- Thank you for joining us!
- Logistics:
  - Mute your microphone
  - Turn on your video!
  - Open the chat window and use this for questions
- A recording of this will be available

AGENDA

PREPARE
- Momentum
- Materials
- Relationships

EXECUTE
- Relationships
- Pitches
- Documents

MANAGE
- Negotiations
- Closing
- Relationships

- **Module 1:** The Fundraising Journey: Steps to Raising Capital
- **Module 2:** The Pitch: Telling Your Story
- **Module 3:** The Proforma: Building a Strong Financial Model
- **Module 4:** The Cap Table: Who Owns Your Company
- **Module 5:** The Term Sheet: The Details Matter

Term Sheets

Joe Leo
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Simple Company Led Term Sheet

- https://nvca.org/model-legal-documents/
- Be careful!
  - Make sure you know what are common terms in your area
  - Simplicity is your friend
  - Do not add complexity unless you have to

Term Sheet

The term sheet is the document that outlines the basic terms by which an investor (angel or venture capital investor) will make a financial investment in your company.

- It should not be a binding legal document
  - They lack detail
  - Don't get locked in
- The value is the negation process, can you come to agreement?
- A non-binding term sheet provides a bridge to the final documents
- Provides a psychological commitment with investor.
- This makes the final documents easier to complete

Three Main Sections to Term Sheet

- Financial terms

- Investor preferences / rights

- Corporate governance

Term Sheet Includes

- Financial terms - Equity
  - Amount raised
  - Pricing / valuation
- Financial terms – Convertible Debt (descending importance)
  - Amount raised
  - Valuation Cap
  - Discount
  - Interest Rate

Valuation / Pricing - Equity

- Pre-money Valuation
  - Value of a company prior to investment or financing
  - Example - $1,000,000 pre-money valuation with 100,000 shares outstanding leads to $10.00 per share.
- Post-money Valuation
  - Value of a company after an investment has been made. This value is equal to the sum of the pre-money valuation and the amount of new financing received.
  - Example - $1,000,000 pre-money valuation with 100,000 shares outstanding (pre-money), if you raise $250,000 you will have 125,000 shares outstanding post-money with a post-money valuation of $1,250,000 (still equals $10.00 per share).

Valuation / Pricing – Convertible Debt

- Valuation Cap
  - Most misunderstood by investors and startups
  - Most impact on dilution
- Discount
  - Typically, 20-25% subject to valuation cap
- Interest Rate
  - Typically, 6-10% per year, simple interest
  - Is **NOT** actually paid annually

Valuation Cap Versus Discount - Example

- Startup raised $250,000 convertible debt with $1,000,000 valuation cap and 25% discount.
- Next equity round is valued at $4 million pre-money with 100,000 shares outstanding ($40.00 per share).
- With discount, the $250,000 in convertible debt results in an additional 8,333 shares being issued.
  - $40.00 x 75% = $30.00 > $250,000/$30.00 = 8,333.33
- With valuation cap, the $250,000 results in an additional 25,000 shares being issued.
  - $1,000,000/100,000 = $10.00 > $250,000/$10.00 = 25,000

Term Sheet Includes

- Investor preferences / rights
  - Dividends
  - Liquidation
  - Anti-dilution

Liquidation Preference

- Determines the payout order in case of a corporate liquidation and / or sale of the company

- Investors often make it a condition for their investment that they receive their investment money back first before other shareholders. Known as a 1X liquidation preference.

- Beware “participating preferred”

Liquidation Preference Example 1

- One investor invests $500K for 33% of company
- Founders sell 12 months later for $750K
- Outcome if no protection for investor:
  - Investor received $250K (half of their original investment).
  - Founders receive $500K
- Outcome if 1X preference and 8% dividend
  - Investor receives 8% of $500K - $40K plus the original investment amount ($540K total)
  - Founders receive $210,000

Liquidation Preference Example 2

- One investor invests $500K for 33% of company
- Founders sell 12 months later for $7.5M
- Outcome if no protection for investor:
  - Investor received $2.5M
  - Founders receive $5M
- Outcome if 1X preference and 8% dividend
  - Investor receives 8% of $500K - $40K plus the original investment amount ($540K total)
  - Founders receive $6.96M

Option Pool

- Pool of shares available to be granted
- Average pool approximates 10% of outstanding shares
- Employee is granted a certain amount of shares that vest over a period of time, priced at today's share price

Most investors require that the pool be established prior to their investment and may require a certain amount be available so as to not be diluted by the option pool.

Option Pool Example

- 1,000,000 shares outstanding at $1.00 / share valuation. Investor invests $250,000 for 25% of company
- Pre money option pool
  - Add option pool of 10% or 100,000 shares
  - Result is 1,100,000 shares / $1,000,000 = $.91~ / share
  - Investor $250,000 for 25% receives 275,000 shares @ $.91~ / share (275,000 * .91 = $250,000)
- Post money option pool
  - Investor $250,000 / $1.00 / share = 250,000 shares
  - Add option pool of 10% (125,000 shares)
  - Result is 1,125,000 shares / $1,250,000 = $.88 / share (250,000 * .88 = $220,000)

Term Sheet Includes

- Corporate governance
  - Board seats
  - Voting / approval rights
  - Information rights

Key Employees

- Founders salaries - influx of cash can alter the incentives and behavior in a company, including such major items as founder compensation as well as minor items like benefits
- Term sheets may dictate how much or if the founder can give themselves as a raise
- Likely will require that founders vest their equity, even if they have previously vested their equity

Board / Governance

- What is corporate governance - how we run the company
- Professional investors want to have checks and balances
- New money means new bosses / governance
- If no board exists, term sheet will call for its establishment
- Term sheet will outline number of board seats required by new investors into this round
- Generally 1 seat based upon 5-member board
- Negotiable

Preferred Shareholder Protective Provisions

- Preferred shareholder approval required for *fundamental* transactions
- Carefully consider the list and thresholds
- Blocking versus affirmative rights
- Minimum ownership requirement?

Management and Information Rights

- Major investors want or require certain rights
- Financial statements, budget, tax returns, etc.
- Carefully consider the list
  - Balance need with interference

Matters Requiring Preferred Director Approval

- Preferred director approval required for certain *operational* decisions
- Carefully consider the list and board makeup
- Blocking versus affirmative rights
- Minimum ownership requirement?

Right of First Refusal (ROFR) and Co-Sale

- ROFR typically runs to company and certain (all?) investors
- Consider which shares are covered by ROFR
- Consider which shares are benefitted by co-sale
- Minimum ownership requirement?

Drag-Along and Tag-Along Rights

Drag Along

- Requires shareholders to vote in favor of specified events – generally exit transactions
- Consider balance of power

Tag Along

- Provides minority interest(s) with protection
- Allows the minority owners to sell a pro rata amount of shares in a sale initiated by the majority
- Designed to prevent majority from stranding the minority in the company

Anti-Dilution Rights

- Two kinds > Full Ratchet and Broad-based Weighted Average.
- Full Ratchet
  - Investor invests $250,000 at $10.00 per share, receives 25,000 shares.
  - Down round occurs and the company raises $500,000 equity at $2.00 per share.
  - Without adding any additional cash, investor's initial shares are increased to 125,000 shares.

Anti-Dilution Rights, Cont.

- Broad-based Weighted Average Protection
  - Formula based. CP2 = CP1 * (A+B) / (A+C)
  - CP2 = Investor Price After Round 2
  - CP1 = Round 1 Per Share Price ($10.00)
  - A = Shares outstanding after Round 1 (125,000)
  - B = Cash invested in Round 2 divided by Round 1 Price (50,000)
  - C = Shares issued in Round 2 (250,000)
  - 10 * (125,000 + 50,000) / (125,000 + 250,000)
  - CP2 = $4.67 which results in the investor’s shares increasing to 53,533 (compared to 125,000 in Full Ratchet)

Term Sheet - Control

- Right to participate in future rounds
- Right to receive the same rights granted in the next round of financing.
- Dictate form of legal documents for the financing.

Term Sheet - Control

- All The Rest
  - Intellectual Property / Assignment of Inventions
  - Confidentiality and Restrictive Covenants
  - Employment Agreements
  - Reimbursement of Costs

Thank You

- Final thoughts
  - All content from these seminars is available
    - www.dsmpartnership.com\raisingcapital
  - Please complete our survey
  - Stay in touch
    - Plains Angels
      – www.plainsangels.com
    - Greater Des Moines Partnership
      – www.dsmpartnership.com
    - Diana Wright
      – dwright@dsmpartnership.com

Raising Capital Seminar Appendix:

October 16, 2020

The Process & The Pitch:

- How to Raise Money – It's a Journey Not an Event – Steve Blank
- Angels Tell the Truth: What Makes a New Company Fundable- Cathy Connett
- 30 Questions Investors Ask During Fundraising – Alex Iskold
- 4 Major Startup Funding Mistakes First-Time Entrepreneurs Make (And How To Avoid Them) - Tero Isokauppila
- Private SaaS Company Valuations: Q3 2020 Update - SaaS Capital
- 11 Questions Founders Need to Ask Investors During the First Meeting
- Why No is the Next Best Thing After Yes – Alex Iskold
- Founders, Beware of Happy Ears – Alex Iskold
- 25 epic, must-read blog posts about fundraising – Alex Iskold
- Your Startup's Competitive Advantage – Alex Iskold
- How a seed-stage company can run a simple and effective board meeting – Alex Iskold
- How to ask me (and others) for an intro – Alex Iskold
- Don't take intros from investors who aren't investing in you – Alex Iskold
- https://www.strictlyvc.com

Pro Forma

- Preparing a SaaS Company for a Capital Raise – SaaS Capital
- How to Read a Balance Sheet (The Not-Boring Version) - Andrew Youderian
- The Finance Function: Looking Back And Looking Forward
- What is LTV:CAC Ratio? – geckoboard.com
- The False Confidence of the LTV/CAC Ratio for Early Stage SaaS Startups – Tomasz Tunguz
- Unpacking the Deep Diagnostic Value of LTV/CAC for SaaS Startups
- The Math Behind SaaS Startup Customer Lifetime Value
- SaaS Cost of Goods Sold for Startups

Cap Table & Term Sheet

- Why Convertible Notes Are Sometimes Terrible for Your Startup. – Mark Suster
- Convertible Notes and Safe Notes – Fred Wilson
- National Venture Capital Association Model Term Sheet
- Summary of Equity Offering Terms – Joe Leo, BrownWinick Law