

## Anatomy of a VC Term Sheet

Or, at least, a glimpse of some important body parts

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BFE Presentation, March 22, 2007

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## What is the Term Sheet For?

- Non-binding documentation of the principal deal terms
  - Uncover fundamental deal problems before spending a lot of time/\$\$ getting the deal done
- There can be some limited binding elements
  - Exclusivity/No shop
  - Expenses

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## Key Concepts/Terms

- Preferred (versus common) Stock
- Dividends
- "Liquidation" Preference
- Anti-Dilution (Full Ratchet vs. Weighted Avg.)
- Redemption Rights
- Tag Along/Drag Along Rights
- Pre-Emptive Rights
- Protective Provisions
- Registration Rights
- And, of course, Valuation

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## Type of Stock

- Common Stock: The plain vanilla stock that founders/management generally have
- Preferred Stock: The Ice Cream Sunday the investors get
  - Preferred Stock will have special rights that reflect the financial, control and downside protection needs of the VC
  - Convertible into Common

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## Dividends

- Rate
  - 8 – 10% fairly common
- Current – paid each year (not common)
- Cumulative – accrues, even if not declared and paid
- Paid When?
  - Generally at redemption or liquidation, but can negotiate different outcomes
  - Option to pay in Common Stock

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## Liquidation Preference

- The amount the investors get before any amounts are distributed to the common stockholders
- Note: This applies to a sale, not just “liquidation” in the ordinary sense
- Issues
  - How much is the preference (1x – 3x or more)
  - Participation after preference (several formulations)

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## Conversion/Anti-Dilution

- Preferred Stock converts into Common Stock at an established ratio
- Anti-Dilution provisions adjust the conversion ratio to protect the Investor's downside (and acts as a hedge against overpaying)
  - "Full Ratchet" = Knock down to the most recent price
  - "Weighted Average" = Adjust conversion price to give effect both to new price and to number of shares issued at new lower price, as a percentage of total capitalization

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## Redemption

- Gives the Investor the right to force the company to buy out the Investment
- Price to include dividends?
- Usually kicks in after 5 or 6 years
- Not often used, as a practical matter, except as a tool to force a sale

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## Tag Along/Drag Along

- Tag Along: Gives the Investor the right to participate in a sale of shares by common stockholders – ensures no loss of control premium
- Drag Along: Investors/control group can force remainder to go along with a sale (no vote against and no holdout minority shareholders)

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## Preemptive Right/RoFR

- Gives the investors the right to participate in future financings. -- Control and Value preservation
  
- Right of First Refusal on Sales
  - Control – effectively prevents sales of shares to third party

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## Other Provisions

- Class voting rights and veto rights
- Board composition
- Information rights
- Vesting of Founder/management shares
- Pay or Lose/Play or Pay
- Registration Rights
  - Demand, Piggy Back

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## The Most Important Part of the Term Sheet

### The Name at the Top

(Know Thy Investor)

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## Liquidation Preferences Illustrated

### Background:

Company has 10 million shares of common stock and 10 million shares of preferred. Issue price of Preferred is \$1.00 per share.

Company is sold for \$80,000,000.

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## Scenario I: No Participation

Scenario 1: Non-participating Preferred with a 1x liquidation preference.

Preferred = \$10,000,000

Common = \$70,000,000

Of course, the Preferred will simply convert in this scenario.

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## Scenario II: Full Participation

Scenario II: Full participating Preferred, 1x liquidation preference

Preferred = \$45,000,000

Common = \$35,000,000

(compare to \$40 million outcome for founders in prior scenario)

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## Scenario III: Capped Participation

Scenario 3: 1X preference, plus participation until 3X is paid.

Preferred: \$30,000,000

Common: \$50,000,000

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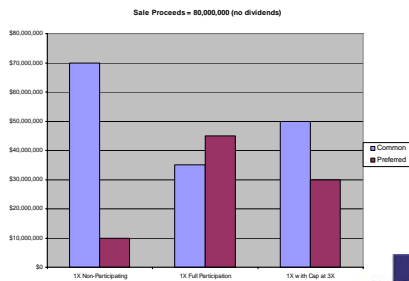
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## Preferences Illustrated



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