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Anatomy of an Investor Term Sheet

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Before you receive a term sheet from an investor, you should consider that traditional investors usually structure a term sheet to protect themselves and, in some cases, get "as much as they can". *Loft Growth Partners* has a fundamentally different view … but that's a topic for later (and yes, see later in this article for insights).

In general, founders and entrepreneurs spend most of their time (maybe too much) worrying about valuation and less time (maybe too little) considering the nature of the partnership and structure of the investment. We say this not to imply that valuation is not important, but that it's not the only important topic.

To be clear, there is no one "right way" to structure an investment – it's all what's agreeable to the Company and the investor. Most investors, however, will address the following issues in some fashion. We'll try to provide some input on what you can expect.:

Investment	A term sheet should spell out the specific amount of the investment. However, since it's quite common for a commitment of more than $1 million to be invested in "tranches" (pieces), it's critical to understand the pacing and any milestones required to trigger future tranches.
Type of Security	It is important to understand what type of stock is being discussed: common stock, preferred stock or participating preferred stock being the three most frequently discussed types. Angel investors (who often will do personal investments of $50,000 to $250,000 or sometimes more) will often participate in preferred or sometimes common stock investments. Sophisticated investors in early to mid-sized businesses (e.g. below $25 million or $50 million in revenue), especially Fund based investors, will almost never invest in common stock. Participating preferred stock is the most common form. What do these terms mean? Common Stock – means the new investor is investing on the same basis as the founders and anyone else investing previously. This is almost unheard of except in "friends and family" investing. Preferred Stock – in general, preferred stock is the most common method of investing for angels and other early investors. Preferred stock means that the investor has "preference" (priority – a.k.a. "ahead" of the common shareholders) in the event of dividends or liquidations. This makes sense as the investors are generally not running the company so they're protected on the downside. In addition, it is not uncommon for preferred stock to have some sort of dividend (also known as a coupon) – meaning it appreciates over time in a compounding and cumulative fashion but often accrued (vs. paid each month or quarter). This dividend is generally referred to as the Preferred Return and is paid before other distributions at exit.

	Participating Preferred Stock – this type of stock is by far the most common for $1+ million investments and/or by more sophisticated investors. It works exactly like the preferred stock reference above, except the investor gets their investment back (sometimes referred to as return of capital) and then "participates" in the equity just like other shareholders. At the end, I'll provide a numerical example to highlight the differences in the 3 types of stock provisions above.
Warrant Coverage	While uncommon with angel investors, it is not uncommon that larger investors will receive warrant coverage. These warrants essentially provide the investor the right to invest more money later on the same terms (or sometimes different terms if that's what is agreed upon).
Pre-Money Valuation	This sets a clear understanding of the company's valuation before the new investment. This is important as often companies will need to "clean up" issues with prior investors, option holders and/or debt holders. Note of caution: we implore founders not to "push" valuation too high in early rounds of financing with friends and family or even with angels. While there's natural tension here – higher valuation means less dilution – it almost certainly means issues later. Aunt Susie and Uncle Harry will not quibble over a $3 million or $5 million valuation for a pre-revenue idea. However, 18 months later, a business with a bit of revenue may not be able to achieve a $3 million valuation with an angel and may therefore experience a "down round" (lower valuation than prior investments). This is emotionally devastating for the founders believing "we worked for 18 months and the company is worth less than before". In fact, the business probably was not worth the prior valuation. Off topic a hint – but please be careful for your sake. In addition to the emotional fatigue, it can torpedo financing if the entrepreneur, friends/family or angels are discouraged by the valuation "decline" and the new investor "walks" as a result. In addition, be careful not to use Vitamin Water, Burt's Bees, Krave or other mega-deals as comparable valuations for early stage businesses. Try to focus on other early stage businesses where possible as valuations and multiples expand as businesses achieve scale. Similarly, using the "one in a thousand" exit is not a fair comparison and investors generally know it (and often discount other things you'll say questioning your credibility).

Ownership	This is simple math… pre-money valuation + new investment = post money valuation. New investor ownership is calculated by dividing new investment dollars by post-money valuation.

For example:

Pre-money valuation	$10 million (67% ownership post money)
New investment	$5 million (33% ownership post money)
Post-money valuation	$15 million

Management Options

If the size of the option pool (usually for management but not founders since they're sizable stockholders) included in the pre-money valuation is not sufficient for the future, it is usually expanded before the new investment in made in the company (part of the "clean up" effort referenced above).

Distributions

Continuing the dialogue above regarding different stock types (e.g. participating preferred stock), it's important to understand what, if any, liquidation preference exists. This means, what distributions (and/or dividends) occur before other shareholders get paid. A 1x liquidation preference is very standard (meaning the investor gets the return of principal before other shareholders get paid). In that case, the distribution "waterfall" would be as follows:

1. First to the investor until the investor has received its Preferred Return,
2. Next to the investor until the investor has received an amount equal to 1x its investment, and
3. Thereafter, to all shareholders pro rata on fully diluted ownership basis.

Important Note:
Higher liquidation preferences in section ii above (e.g. 1.5x or 2.5x) are not uncommon, especially in two situations:

Higher risk – one way to account for a riskier investment is to allow the investor to get a multiple of its money back later before other investors get paid. Very common.
Higher valuation – a way to justify a "stretch valuation" is to provide a higher preference, meaning the new investor owns a smaller part of the company (as a result of higher valuation) but gets 1.5x or 2x their money back first. Also quite common as it protects the investor on the downside associated with the "stretch".

Governance	It is important to understand what the Board composition post-investment looks like. Unfortunately, too many small companies have large boards. A 3 person board is quite sufficient for governance purposes but 5 people is more common (including due to realities of who is "already there"). Avoid larger boards where possible. If a new investor is a substantial minority shareholder, they will often have 2 seats with the founder(s) and prior investor(s) collectively having 2 seats and an independent director rounding out the Board. Where possible, try to have a mutually agreed upon outside director. Their experience can be quite helpful and they can be neutral in the event of a future disagreement. If Board committees are established, it is common for new investors to chair or sometimes control the audit and/or compensation committees as a way to protect their investment.
Consent Requirements	Most term sheets associated with minority stakes will provide a list (long list) of situations that will require approval of the investor. This is a place where we have a fundamental difference of perspective with traditional investors. Founders and management teams should expect a lengthy list of 15 (on the short side) to 50 (on the long side) situations that require consent of the new investor. I despise the term "blocking rights" but it accurately describes what this list represents ... situations where the investor can veto actions of the company. In a minority situation, there should be very few, if any, affirmative rights – meaning the new investor can force things upon the management (e.g. must hire this person, must build a new plant, must move headquarters location). (As an industry partner – our list of consent requirement is so short you could count them on a hand or two. Why? We believe, as an industry partner NOT an investor that we only need to make sure that we "keep the apple as an apple". What does this mean? Well – if we partner with Joe and Judy Smith in their apple business, we just want to ensure that the business remains generally intact. If we learn one day that we own 30% of a pet iguana farm, that's not a happy day. So, for example, no opening hamburger stands with the investment money. That's what I mean when I talk about keeping the apple an apple.)
Exit	It's critical for founders, management and the investor(s) to have clear understanding of the timing of their investment. Most investors will require some clarity around the duration of the investment. Ensure you're on the same page in the term sheet. (Speaking only for us, alignment on timing – and everything else – is key).

Other

It's very normal and important to understand:

- Conversion – the timing/nature of conversion to common stock
- Anti-Dilution – investors will always get protection from future "down rounds"
- Pre-emptive Rights – investors will always get rights to purchase additional shares should there be subsequent financings. Most common is a pro-rata right, meaning if the investor owns 30% of the company they're assured of the right to purchase shares in the future to maintain their 30% ownership.
- Right of First Refusal – it's important to have clarity around who has the right to purchase shares should an existing shareholder wish to sell shares.
- Co-Sale Rights – these provisions essentially say that new investors want the right to sell their shares if existing shareholders sell their stock and vice versa (referred to as Tag Along and Drag Along Rights).
- Governing and Contingent Documents – most investments will require updates or more fundamental changes to prior Articles of Incorporation, Shareholder Agreements and/or Limited Liability Company agreements (the latter often converting to a Corporation). Similarly, some document will be required to be completed prior to an investment (e.g. option plan if one doesn't exist). Term sheets will generally specify the kinds of changes required or new documents to be completed.
- Exclusivity – it's relatively unheard of for investors to consider doing substantial work (due diligence or drafting of legal documents) without knowing they and the company are proceeding together exclusively. Similarly, it's generally accepted that each party covers their own expenses upfront but they are taken from the proceeds of the investment at closing. Finally, since investments are not final until formal contracts are signed, investors will generally require the company to agree to cover the investors expenses if the company "changes their mind" – meaning the terms of the deal don't change but the founders, for example, wake up one day and just decide not to do the deal. It does not compensate for the time, but it's only fair regarding the out-of-pocket expenses.
- Binding/Non-Binding – generally term sheets are non-binding (again until definitive contracts and agreement are signed). However, certain provisions like Exclusivity are generally binding.
- Expiration – there's always an expiration period on the term sheet – generally a week or so. Sometime more or less.

As promised, here's an example of the waterfall of distributions given various scenarios reference above. (The term waterfall comes from the old "barrel over the falls" analogy – meaning first it goes this way, then it goes that way, etc. – or first this payout happens, then that payout happens, etc.)

The "Waterfall" of Distributions: 3 Examples

	Common Stock	Preferred Stock	Participating Preferred Stock
Pre-Money Valuation	$1,500,000	$4,000,000	$7,000,000
Investment	$200,000	$1,000,000	$3,000,000
Post-Money Valuation	$1,700,000	$5,000,000	$10,000,000
New Investor Ownership	12%	20%	30%
Preferred Return Rate		10%	10%
Enterprise Value at Distribution	$10,000,000	$15,000,000	$40,000,000
Distribution to New Investor			
- Preferred Return (Assumes 5 Years)		$610,510	$1,831,530
- Return of Principle (1x Liq Pref)			$3,000,000
- ProRata Share of Common Shares	$1,176,471	$2,877,898	$10,550,541
- Total	$1,176,471	$3,488,408	$15,382,071
Distribution to Founders/Prior Investors	$8,823,529	$11,511,592	$24,617,929

Finally, I referenced earlier that we generally don't subscribe to the conventional venture capital principles and funding approaches. VCs or investors get a bad rap … and, in some cases, deservedly so. We are NOT investors ... we're industry partners that happen to come with a bucket of cash. As such, in everything we do, including our approach to term sheets, we approach things in quite a different fashion.

I hope the information is helpful in giving you things to think about …