DISSECTING A TERM SHEET:

INTRODUCTION TO THE ECONOMIC IMPACT OF THE TERMS YOU AGREE

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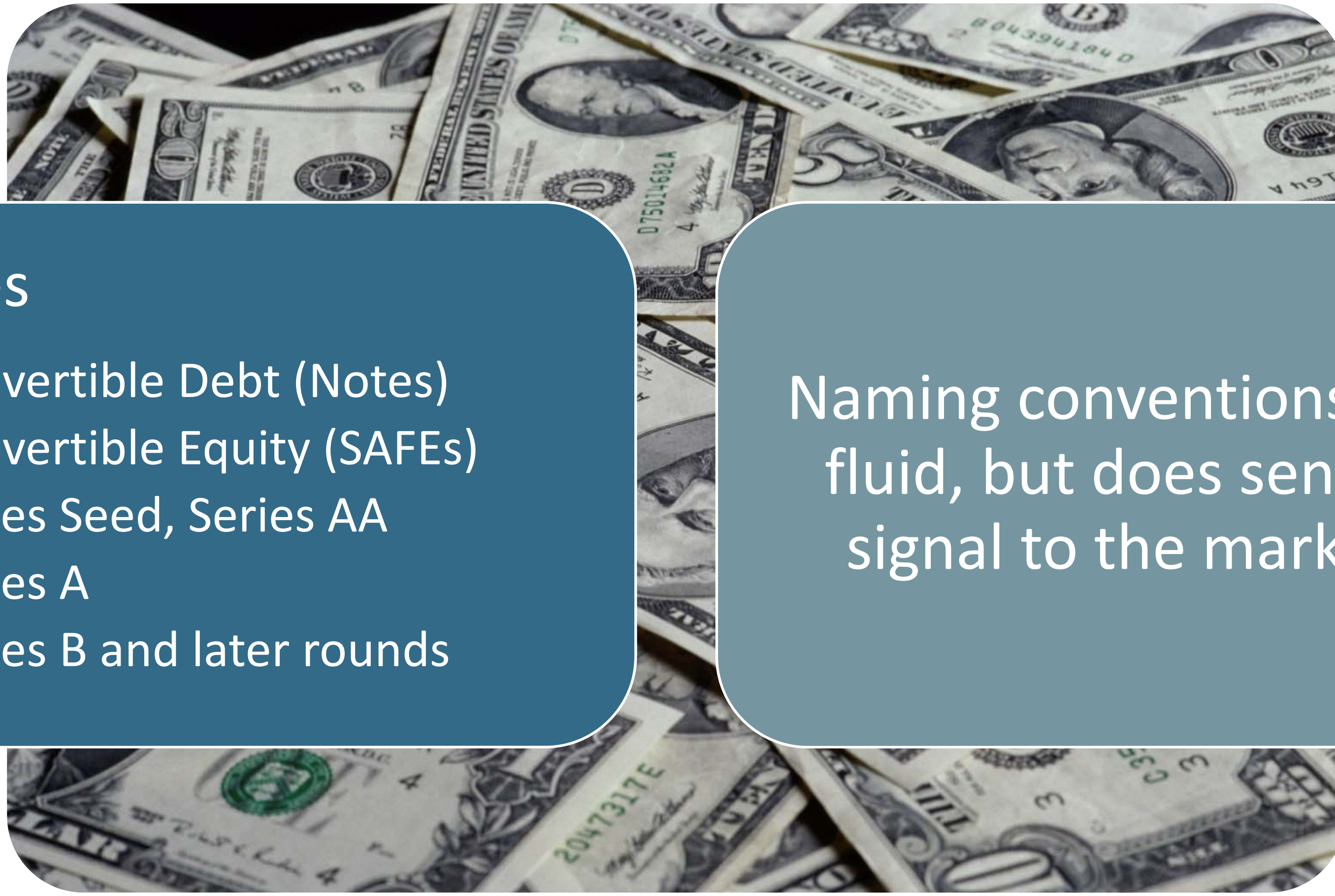
What does it mean to “Raise Money”?

- Different funding sources and expectations
  - Traditional lenders
  - Family and friends
  - Angels
  - VCs
- **Equity Financing**: Raising capital by selling an ownership interest in the company.
  - What is the form of ownership interest?
    - Stock - Common Stock vs. Preferred Stock
    - Convertible instruments
  - What rights are associated with that ownership interest?
- Term sheets
  - Ensures there is a meeting of the minds on business terms
  - Saves on legal costs
  - Non-binding for most provisions

Possible Types of Early Stage Financings



Types

- Convertible Debt (Notes)
- Convertible Equity (SAFEs)
- Series Seed, Series AA
- Series A
- Series B and later rounds

Naming conventions are fluid, but does send a signal to the market

Convertible Notes

Why use?

- Expediency
- Debt sits above equity
- Allows investors to convert into their investment into equity with certain triggers
- Defers valuation discussion – sort of.

Convertible Notes (continued)

What are investors looking for?

<u>Key terms</u>

- Principal amount due at a maturity date
- Interest
- Conversion into preferred stock
  - "Qualified Financing" or "Next Equity Financing"
  - Discount
  - Cap
  - Cap and Discount – investor typically gets the lesser of the price per share calculated with the discount and the cap.

Convertible Notes (continued)

Examples

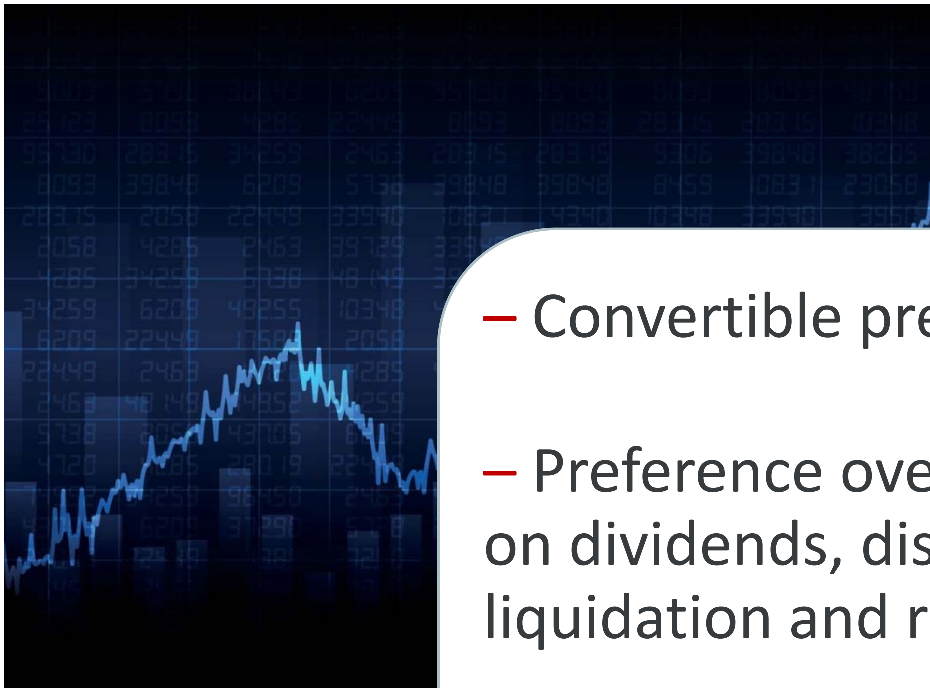
- $5M Cap
  - Investor invests $25K using convertible note with a $5M cap.
  - Series A round has $10MM valuation. 2MM shares of common stock outstanding immediately prior to Series A. Series A Per Share price of $5.00.
  - $25K loan converts into Series A at a price of $2.50 per share ($5MM/2MM shares). Investor gets 10,000 shares which is worth $50K. A new series A investor would only get 5000 shares.
- 20% Discount
  - Investor invests $25K using convertible note with a $5M cap
  - Series A round has $10MM valuation. 2MM shares of common stock outstanding immediately prior to Series A. Per Share price of $5.00.
  - $25K loan converts into Series A at a price of $4.00 per share (80% of $5.00). Investor gets 6250 shares of Series A worth $31,250. A new Series A investor gets only 5000 shares.

Convertible Notes (continued)

SAFEs vs. Convertible Notes

- SAFEs not a debt instrument
  - Maturity date
  - Interest
- Additional streamlining for closing
- Do investors have a preference?

Series A Terms



– Convertible preferred stock

– Preference over common stock on dividends, distributions, liquidation and redemption

– Control provisions also typically negotiated

Price/Valuation

- How much of the company is the investor going to own and at what price?
  - **Pre-Money Valuation**: Value of the company before investment
  - **Post-Money Valuation**: Pre-Money Valuation + Investment Amount
  - **Price Per Share** = Pre-money Valuation/Pre-Money Capitalization
  - Fully diluted basis
  - New Shares Issued/Post-money shares outstanding = Investment Amount/ Post-Money Valuation

Make sure discussions are clear – *"I'll invest $5 million at a valuation of $20 million."* Pre-money or post-money?

Price/Valuation (continued)

Excerpt from term sheet

Price Per Share:	$[__________] per share (based on the capitalization of the Company set forth below) (the "Original Purchase Price").
Pre-Money Valuation:	The Original Purchase Price is based upon a fully-diluted pre-money valuation of $[______] and a fully-diluted post-money valuation of $[_______] (including an employee pool representing [__]% of the fully-diluted post-money capitalization).

Option Pool

- Option pool is the number of shares of common stock the company reserves to compensate employees, consultant, advisors. Essentially setting aside a percentage of the company.
- Larger option pool lowers the effective pre-money valuation of the company for the founders because a larger portion of the company's pre-money value is attributed to the option pool
- Competing interests of founders and investors.
- Scenario
  - Offer 1: Pre-money valuation of $10MM, $5MM new money with a 10% post-money option pool
  - Offer 2: Pre-money valuation of $12MM, $5MM new money with a 20% post-money option pool

(See Pro Forma Effects in Excel)

Liquidation Preference

How are proceeds shared in a **liquidity event** for the company

Preferred get the greater of their liquidation preference or what they would get if they converted to common stock.

Preference: A multiple of the original investment per share is returned to the investor before common stock receives any proceeds (1x, 2x, 3x….)

Liquidation Preference – Participation Rights

- No Participation

"First pay [one] times the Original Purchase Price on each share of Series A Preferred (or, if greater, the amount that the Series A Preferred would receive on an as-converted basis). The balance of any proceeds shall be distributed pro rata to holders of Common Stock."

- Full participation

"First pay [one] times the Original Purchase Price on each share of Series A Preferred. Thereafter, the Series A Preferred participates with the Common Stock pro rata on an as-converted basis."

- Capped participation

"First pay [one] times the Original Purchase Price on each share of Series A Preferred. Thereafter, Series A Preferred participates with Common Stock pro rata on an as-converted basis until the holders of Series A Preferred receive an aggregate of [two] times the Original Purchase Price (including the amount paid pursuant to the preceding sentence)."

- More complex with additional rounds

(See Pro Forma Effects in Excel)

Dividends

- Distribution of profits to shareholders. Can be in cash or in stock.
- How do investors think about dividends?
- Cumulative vs. non-cumulative
  - "The Series A Preferred will carry an annual [__]% cumulative dividend [payable upon a liquidation or redemption]. For any other dividends or distributions, participation with Common Stock on an as-converted basis"
  - "Non-cumulative dividends will be paid on the Series A Preferred in an amount equal to $[_____] per share of Series A Preferred when and if declared by the Board and prior and in preference to any declaration or payment of any other dividends."
  - "Dividends will be paid on the Series A Preferred on an as-converted basis when, as, and if paid on the Common Stock"
- Less of an issue in early-stage financings. Company's profits should be used to grow the company.

Anti-dilution Protection

- Protects investors in the event of a down round
- Most common mechanism is adjusting the conversion ratio of preferred shares to ordinary shares → Series A investors get more than one common share for each preferred share they hold
  - Economic value
  - Voting
- Full-ratchet (most investor friendly)
- Weighted average
  - Broad based weighted average (most founder friendly)
  - Narrow based weighted average (middle ground)
- Carve-outs

Other Economic Terms

- Pro-Rata Participation Rights in Future Rounds
- Pay to Play
- Redemption Rights
- Warrants

Thank You – Questions?

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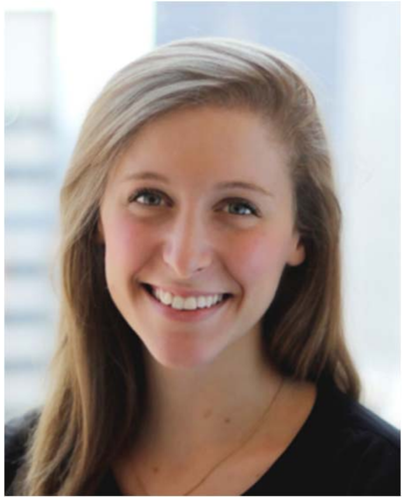

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