Deal Terms and Trends

ACA New England Regional Group
Angel Education Series
Panelist Introductions

• Jean Hammond
• Jess McClear
• Christopher Mirabile
Agenda

• Big Picture
  – Equity and other company supports

• Equity Deal Terms (Preferred)
  – Governance, Management and Control
  – Investor Rights
  – Exit/Liquidity
  – Deal Economics
    • Detailed examples of impact of some economic terms

• Convertible Notes

• Deal terms Q&A
Equity is the “Standard” for Angels & VCs Deals

- Companies that are going to move to “life style” companies are more likely to fit with debt
- ‘High impact’ companies and actual non-profits can also be funded with high return royalty debt
- Everyone should agree that there is a desire to exit in next 2-6 years
- The entire pie needs to grow
- Available in 506 B and 506 C

Royalty debt provides “ability to pay” method
Debt can be lower risk For “investor”
Convertible Notes & SAFEs are early stage steps for Equity
Equity
Deal Terms Define a Contract

- The company and investors set up terms to give each party specific rights within SEC rules and other corporate law.
- Term sheets are used in most early stage financings and outline the key deal points.
- Final documents are binding and contain details for concepts in term sheet.

**Founders, Company, & Angel Investors** → **Diligence** → **Negotiation of the Term Sheet** → **Closing with Binding Legal Documents**

4 to 8 weeks
Term Sheets for Series A Preferred Stock Financings

Used by VCs for decades...increasingly used by angel groups

- Model documents available
- NVCA (www.nvca.org)
- Some New England angel groups have model term sheets
- On the Web, other models:
  - Angel Capital Association
  - Seed docs: www.startupcompanylawyer.com
Term Sheets can Include Many Terms

- Instrument: Equity or Convertible Debt
- Pre-Money Valuation & calculation
- Liquidation preference
- Dividends
- Option Pool Size
- Anti-Dilution
- Investor approval rights
- Preemptive Rights (Participation in Future Financings)
- Non competes/invention agreements
- Board seats and Observers
- Board approvals
- Information rights
- Founders vesting
- Registration Rights
- Drag Along Rights
- Redemption Rights
- Rights of First Refusal & Co-Sale Rights on Transfers
- Deal cost allocation
- Type of deal documents

Deal specific details:
- How much to raise
- Date of Closing
- Rolling Close, etc.
Terms Basically Deal with Issues Around:

- Governance, Management and Control
- Investor Rights
- Exit/Liquidity
- Economics

Some terms (e.g. Registration) may be left out to simplify the documents and the cost to develop them.
Management and Control

- Board Seats & Observers
- Information rights
- Founders vesting, non competes, etc.
- Board and Shareholder approvals

Protection

- Anti-Dilution
- Preemptive Rights (Participation Rights in Future Financings)
- Rights of First Refusal / Co-Sale Rights

Exit/Liquidity

- Drag Along Rights
- Registration Rights
- Redemption Rights

Economics

- Instrument & Discounts
- Pre-Money Valuation
- Liquidation preference
- Dividends
- Option Pool Size
- Fully Diluted Equity Calculation
Entrepreneurs have Concerns Too

- Loss of control over company
- Economic dilution – giving away lots of ownership
- Risk of losing ownership of stock if fired or resign
- Running out of money
- Security interests in assets and personal guarantees
- Fit and relationship with investors / value-add of investors

→ Worth keeping in mind that some of our favorite tools are big hot buttons for entrepreneurs...
Management and Control of investment

- Board Seats & Observers
- Information rights
- Founders vesting, non-competes, etc.
- Board and Shareholder approvals
Board Seats

• Right to elect member(s) of the Board - “Series A Director”
• Board Observation Rights – Observation Rights Letter
• Confidentiality Provisions, and
• Term limited (sometimes) to continued investment participation
Investor Information Rights

- Receipt of Quarterly Reports from Management
- Receipt of Copies of Financial Statements
- Inspection Rights (all stockholders have)
- Annual audit, other covenants
• Sometimes:
  – Founder must place his stock under ownership restrictions that vest
  – Founders and employees agree to inventions assignment, and non-compete
  – Key person insurance
Board and Stockholder Approval Rights

• Consent of Board for some activities,
  – Budget, borrowing, etc
• Consent of holders of some percentage of Preferred Stock required for others
• Likely actions requiring such consent
  – Amendment of charter or by-laws
    • in a manner adverse to Preferred Stock
    • to increase number of shares of Preferred Stock
  – Authorization of stock having senior/pari passu rights
  – Redemption of stock or payment of dividend
  – Sale or merger of Company
• Drag Along Rights
• Registration Rights
• Redemption Rights
Drag-Along Rights

• If Company’s Board and holders of some % of Preferred Stock and Common Stock approve a Change of Control transaction, affected shareholders agree to vote their shares in favor of & to participate in transaction

• “Affected shareholders” usually includes
  – all holders of Preferred Stock
  – certain holders of Common Stock
    • Founders
    • Holders of greater than specified percentage of stock
    • All holders of Common Stock
Registration Rights (for IPO)

• Right to have Company register Common Stock into which Preferred Stock is converted

• Alternative term sheet provisions:
  – Preferred Stock will receive registration rights pari passu with and substantially the same as registration rights granted to others
  – Detailed listing of rights
Redemption Rights

• Holders of Preferred Stock have right to require Company to redeem their shares after a certain period of time over a specified period of time
• Redemption price is usually the purchase price plus possibly a specified cumulative return
• Frequently included as a charter provision
• Very infrequently used these days
  – But there is an increased interest in royalty based financing
• Tiered timing
• Anti-Dilution
• Preemptive Rights (Participation Rights in Future Financings)
• Rights of First Refusal / Co-Sale Rights
Anti-Dilution

• Adjustment stock purchase price if there is a down round

• Alternatives
  – Weighted average
    • Broad-based
    • Narrow-based
  – Full ratchet
Rights of First Refusal/ Co-Sale Rights

• Company first and Investors second have right of first refusal to any shares of Company’s stock proposed to be sold by:
  – Founders
  – Current and future employees holding greater than [1]% of Company’s stock
  – Sometimes investors

• If Company and Investors don’t buy all of the stock offered, Investors have a “co-sale” right to sell their proportionate shares of the stock being sold
Participation Rights in Future Financings

• Right to participate in future issuances of stock by Company in order to maintain proportionate ownership
  – Subject to change in “next” term sheet
• May or may not include outstanding options and warrants
• May expire if not exercised by an investor at each opportunity
• Instrument & Discounts
• Pre-Money Valuation
• Liquidation Preference
• Dividends
• Option Pool Size
• Fully Diluted Equity Calculation

Economics
## Valuation

<table>
<thead>
<tr>
<th>Founders stock</th>
<th>$2.2M (55%)</th>
<th>% post</th>
</tr>
</thead>
<tbody>
<tr>
<td>+ Option pool</td>
<td>$0.8M (20%)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Pre-money</th>
<th>$3.0M</th>
</tr>
</thead>
<tbody>
<tr>
<td>+ Money invested</td>
<td>$1.0M (25%)</td>
</tr>
</tbody>
</table>

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Post-money value $4.0M
• Right to be paid before other classes of stock:
  – Non-Participating: Either paid or converts (not both)
  – Participating: Right to be paid before common; then to participate as common
    • “Double Dip” & divergent incentives

• Most recent class of stock likely has seniority over earlier classes
Dividends

• Dividends paid in preference to common
• At a set rate
• Can be authorized but not paid except in certain conditions
• Somewhat rare in angel deals … time to exit may be many years
### Examples

<table>
<thead>
<tr>
<th>Step 1</th>
<th>Initial Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>% ownership</td>
<td>40%</td>
</tr>
<tr>
<td>Post-Money Valuation</td>
<td>$3,750,000</td>
</tr>
</tbody>
</table>

### Economic Terms

- **Stock Class**: Preferred
- **Dividends**: 8%
- **Liquidation Pref**: 1x
- **Stock Option Pool**: 20%
- **Anti-dilution calc**: basic
- **Founder's Vesting**: 3 years
- **Participation**: Yes
Step 2  Company is sold in Year 4  Scenario 1  Scenario 2  Scenario 3

<table>
<thead>
<tr>
<th>Selling Price: all cash</th>
<th>$2,000,000</th>
<th>$10,000,000</th>
<th>$30,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>3% transaction costs</td>
<td>3% $ (60,000)</td>
<td>$ (300,000)</td>
<td>$ (900,000)</td>
</tr>
<tr>
<td>Net Proceeds to distribute</td>
<td>$1,940,000</td>
<td>$9,700,000</td>
<td>$29,100,000</td>
</tr>
</tbody>
</table>

**Preferred Stockholder**

<table>
<thead>
<tr>
<th>Original Investment</th>
<th>$1,500,000</th>
<th>$1,500,000</th>
<th>$1,500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preference in excess of 1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends for 4 years</td>
<td>$480,000</td>
<td>$480,000</td>
<td>$480,000</td>
</tr>
<tr>
<td>Amount to Preferred Shareholders</td>
<td>$1,980,000</td>
<td>$1,980,000</td>
<td>$1,980,000</td>
</tr>
</tbody>
</table>

Amount remaining for Common and 40% to Preferred

$ $7,720,000 $27,120,000
Term Sheets

- **Summary**
- **Initial valuation and % ownership**
  - Other terms can offset variances
  - The math reflects the investment risk
    - Most deals will not have a positive return
    - The majority of the portfolio return will come from 20% of the investments
- **Popularity of Preference Terms**
  - Seems to depend on the supply of capital
  - Varies by region, firm, industry, and cycle
Concluding Thought

When crafting a term sheet, think ahead to the next round:

• Terms should be acceptable to future investors
• Don’t extract anything unusual that will need to be undone in later rounds
  – Crazy pre money valuations
  – Ratchets
  – Inordinate # of board seats
  – Special rights to angels
Convertible Notes

Convertible Notes go in and out of style, and should be used appropriately
• Earliest money to avoid pricing
• Bridge to a very likely round
• Sometimes preserve existing shareholders if the only money

Features
• Trigger – end of term, qualified financing
• Caps and tranches

Benefits include ability to raise over time and sometimes cost

Problems include devil in the details, likelihood terms will not be honored, management vs. investors, postponing the inevitable; bridge to nowhere
Notes: Steps to Improve Investor Protection

• Make the term of the note long enough to grow the value
• Have a note-holder agreement,
  – name the board members
  – allocate protective provisions
• Set price and the date that notes will auto convert into a priced round
  – Add valuation cap to the conversion price
  • Aligns interests of the company and the early investor
  – Can put the discount in common share warrants
  • warrant holders can convert
  • discount can’t be negotiated away as easily
S.A.F.E.

- A convertible note that is not debt but a promise to deliver equity in the future
- Popular in California
- No equity round – they go away
Historically terms have been less standardized than venture capital deals

Valuations are higher in CA and NYC

A trend is to move toward standard “vanilla” term sheets for preferred stock with:

- Liquidation preferences
- Anti-dilution adjustment
- Board and information rights
- Participation rights
Few changes in standard preferred stock terms has occurred over the last decade

- Liquidation Preference Multiples
- Participation
- Ratchets
- Redemption
- Registration Rights
- Convertible Notes are “in” – unless they’re “out”

Impact on use of NVCA forms
A Few More Issues

• Series Seed vs Series A
  – What do we call them and why
• 506 C
  – Can be costly
  – Not a good mix with 506 B
Angel Investing Returns

• Portfolio Returns on 3 things:
  – Entry Valuation
  – Time to Exit
  – Deals you don’t do

• Early investing and early exits for angel $$

• Capital Efficiency Model:
  – Lean startups without VC $
Q&A
Resources and Contact Information

• Website:
  – Angel Capital Association: [www.angelcapitalassociation.org](http://www.angelcapitalassociation.org)

THANK YOU