

Term Sheets

Receiving a term sheet from private equity investors is a coup, especially in today's cautious capital markets. But don't rush to sign the dotted line, says Merrill Mason, a FastTrac facilitator and co-founder of Hutchison+Mason PLLC, a Raleigh, North Carolina-based legal firm that specializes in business and technology law.

"In fact, signing right away might be considered unsophisticated," Mason explains. "Venture capitalists aren't going to give you their best offer right out of the gate. Negotiating the term sheet is part of the due-diligence process."

A term sheet is a letter of intent that outlines how much money investors are prepared to give you and under what conditions. Some term sheets consist of a page or two while others are lengthy documents. "Longer term sheets may seem onerous, but are actually better for entrepreneurs because they address more issues, making less to hash out with lawyers later," Mason says.

Certain provisions in the term sheet aren't going to change, but there is flexibility in other areas. Entrepreneurs should pay particular attention to the following sections:

Pre-money valuation — What the company is worth before the investors' money is invested. This is important because ownership is calculated by dividing investors' contribution by the post-money valuation. For example, if your company is valued at \$12 million and investors then kick in \$4 million, they will own 25 percent (\$4 million divided by the \$16 million post-money valuation).

Investors typically drive the pre-money valuation. It's what they perceive your company to be worth. You may be able to inflate this number if you have multiple groups of investors interested in your firm, which gives you more leverage. Although common during the late '90s, that's rare today.

Liquidation preference — How proceeds are distributed in the event of a sale. Basically, preferred stockholders (your investors) get their early money out first. If they invested \$1 million, they get back \$1 million, plus accrued dividends, before the ownership split takes place. For example, say that investors gave you \$1 million and now own one-third of your company. Later, the company is sold for \$10 million. Yet before the ownership split, investors receive their initial \$1 million off the top. Then they get \$3 million of the remaining \$9 million and you get \$6 million. "This may sound unfair, but that's the way the game is played," Mason says. "And it typically only makes a difference on low sales."

Also, there may be "multiples" in the liquidation preference, which means investors get X times their original investment from proceeds before the ownership split.

Option pool — Stock reserved for allocation to future employees, consultants and directors also affects the entrepreneur's stake. Suppose that your pre-money valuation is \$4 million, investors are giving \$2 million and they ask for a 20 percent option pool. That 20 percent comes out of the founders' hide. Investors still own one-third, but instead of 66.7 percent, the founders now own 46.7 percent (66.7 percent minus the 20 percent).

Milestone or tranching closings — Investors may agree to give you a certain amount of money, but dole it out as your company meets certain milestones.

Price protection — Funding is typically raised in a series, and if all goes well, share price of stock increases with each round. Price protection is a mechanism that protects investors if share value doesn't go up, increasing investors' ownership by adjusting the conversion rate of the existing preferred stock. You can't avoid price protection, but there are ways to make it less painful, such as "weighted average ratchet" which results in less dilution of founders' stock.

Board composition — Make sure the board is balanced. Typically, management gets two seats, investors get two seats, and one or two outside industry experts are asked to serve as board members.

Founder vesting — Although founders typically own their stock at the time of the investment, investors may require those shares to be vested over a period of years. This may be tough to swallow, but makes sense from the investors' perspective. They're investing in your management team and want to make sure you stick around.

Remember, investors will take your measure as you discuss the term sheet. "Be careful not to get overly acrimonious and poison the well," Mason says. "You're going to be sitting on the same side of the table with investors after the check is signed. You want to be able to live with them."