Term Sheet for Start-Ups: Key Clauses & Components

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Term Sheet For Startups

When start-ups are inching towards the final steps of obtaining funds through equity financing, a document known as a 'term sheet' is typically drafted. This is a non-binding document that is drawn up on the basis of discussions that have taken place between the start-up and potential investors. This sheet reflects the crucial details of the discussions and acts as a buffer document before the final agreement. It is also referred to as the Letter of intent or Memorandum of Understanding (MoU) and ensures that both parties understand their duties, powers, and liabilities before reaching a final decision.

A term sheet also defines the rules of engagement and what the Shareholder's Agreement (SHA) would look like. Since both investors and founders of the company are likely to negotiate and compromise on key terms, a term sheet makes allowances for the same, leading to an increased chance of creating a profitable business.

Key Components Of A Term Sheet

Such a document predominantly contains protective provisions for investors as well as founders to determine the future of the company. These terms and conditions are usually negotiable and subject to alteration, provided both parties are mutually consenting. Notably, although the term sheet is non-binding in theory, the clauses pertaining to confidentiality, exclusivity and dispute resolution are still binding. These clauses can be broadly identified based on their ultimate translation into the agreement in the following ways:

I. Valuation

This crucial clause allows investors to ascertain the value of the company to determine the investment amount (raise) in exchange for control. There are multiple ways to value a company, such as discounted cash flow or return on equity. It is hence important for investors to identify key areas and infer what approach to take in performing valuation – asset approach, income approach or value approach. Due to the dynamic nature of each approach, the results are based on several different factors associated with the attributes of the company such as size, financial records, profit maximisation and so on.

Understanding valuation:

- Pre-valuation & Post-valuation

The amount a founder aims to raise is directly correlated to the dilution of the overall shares of the company. While analysing pre-money valuation, it is important to exclude the option pool percentage to determine effective pre-money valuation; this provides an exact figure of a founder’s equity, thereby protecting their position from dilution.

Post-money valuation is the final figure that emerges after a round is closed. It comprises an investor’s equity, a founder’s equity and the Employee Stock Ownership Plans (EOSP). The rules of dilution dictate that an increase in outside investment dilutes the existing position of the shareholders.

- Fair valuation

  Investors determine the amount they are willing to invest based on the method of valuation. If founders are intent on keeping multiple rounds of funding, it becomes their responsibility to optimise valuation by ensuring a pragmatic scenario for the next round and allowing only a limited portion of the equity to the investors.
- Balancing valuation and dilution

  The dilution can vary depending on the type of investors involved. It would be less in case there are angel investors; more if there are VCs. Understanding how long money would last in a particular round could help achieve a realistic picture for the next rounds. Analysis of potential spending would determine the optimal allocation of the funds intended to be raised; if the funds are higher than the requirement, the founders’ risk over control is higher. Conversely, if it’s low, there would be a requirement to opt for alternative funding or another round.

II. Control

The control of the company heavily relies on the funding factor rather than the founding factor, since the longevity of the operations depends on the financial position of the company. This is why a pragmatic clause is inserted in the term sheet to determine whose control would remain and to what extent. As an outcome of an investment, investors set certain ownership targets based on a portion of control over the company they receive in form of equity, including board seats and other exclusive rights over information, such as financial statements.

A Monthly Management Information System (MIS), containing the performance of business or inspection rights to protect the investor’s interest is set up. The level of risk taken by the investor also determines the rights of control they may obtain.

Understanding factors affecting control of parties:

- Preemptive rights, anti-dilution and super pro rata

  Preemptive or pro-rata rights allow the existing shareholders to invest in the company’s later stocks prior to anyone else. Anti-dilution rights protect existing shareholders and maintain the percentage in case new shares are issued. These common clauses included protecting the interests of an investor.

  Super pro-rata right is an investor tactic to retain the right to purchase multiple existing shares in the future to avoid dilution. However, this move restricts investment from other investors and leads to the company being subjected to a higher level of control by existing shareholders.
- Board seats

  Although founders of new start-ups have the upper hand in deciding the constituting members of the board, every round of investment dilutes control as the number of board members increases. To ensure fair governance, the clause should contain the proper details of board representatives nominated by investors.

- Employee Stock Ownership Plans (ESOP)

Risk-bearing members, aside from the founders and investors of the team, receive shares under ESOP. The shares are generally valued at a 10% pool, however, this figure can be increased or decreased with each round. The dilution for the ESOP pool needs to be determined to determine whether it'll be diluted owing to a founder's equity or the investors'. Moreover, it should be noted that the shares can be bought back by either party.

III. Exit Economics

Exit economics or exit rights are concerned with the Liquidation Preference (LP) of investors. An exit is generally predicted to happen around five years from the year of investment to allow the investors to encash their gains and repay any limited liability partners. These rights, further discussed below, may either be obligatory or absolute, depending on the terms outlined in the exit clause. However, due to this clause, investors obtain not only a right to encashment of their securities but also the right to sell them to a third party in case the company fails to meet its obligations.

In an aggressive move, investors may impose a buy-back of shares, create an Initial Public Offering (IPO) of the shares or reconstitute the board to obtain full voting rights. This in turn enforces investor control over founders or triggers a strategic sale of shares, including founder's equity to prospective buyers via drag-along rights.

Understanding exit clauses:

- Liquidation Preference (LP)

The investor has the right to provide their liquidation preference in an event of liquidation of the company. This helps reduce the downside risk of the investor in an exit event. There are two types of LPs provided i.e., non-participating LP (straight) or participating LP (double-dip).

The founders should be careful to not allow anything beyond 1x LP since the higher the LP, the more difficult it is for founders to equitably divide the remaining funds in the liquidation process.

- Tag along rights

These rights provide minority shareholders with the ability to sell their shares if a majority shareholder is negotiating for an increased stake. This gives minority shareholders greater liquidity and in the case of the company being sold, financial and legal protection. They strongly benefit minority shareholders since they are granted the same benefits as majority shareholders.

The downside of these rights is that majority shareholders might be discouraged from investing in the company. The selling process of rights could also be made harder, with several minority shareholders blocking the sale. In this case, drag-along rights are a clause favoured by majority shareholders to provide a balance to the sale and acquisition of shares.

- Drag-along rights

In the event of mergers, acquisitions, business failure or when the company is in survival mode, investors find buyers for their shares and can further also sell other shares. Though sometimes unfair and coercive to the rights of minority shareholders (it requires minority shareholders to sell their shares) this technique can be effective for securing a higher valuation of the company.

IV. Founder’s Treatment

As the parent or creator of a company, it is natural for founders to be protective of their assets. Therefore, clauses pertaining to the treatment of the founders have to be negotiated, ideally in a manner that allows a fair approach by balancing the personal involvement of the founding members and their relationship with investors.

Understanding clauses concerning the founders:

- Founders’ vesting clause

The vesting period is an amount of time wherein the founders are earning by way of their shares which have been vested over a while. They receive these in instalments after a cliff period of one year.

The vesting clauses are added to protect the interest of everyone in the company since several companies fail to make it through the initial stages owing to conflicts between founders.

- Founders’ reverse vesting

If a founding member is fired before the vesting period ends, for causes such as misconduct or negligence, their restricted shares can be bought back. However, if a founding member leaves without such a cause, and does so on good terms, after the completion of the cliff period, the founder takes their shares with them. The remaining shares get merged with Employee Stock Ownership Plans (EOSPs) or as decided by the shareholders.

- Founder lock-in

Founders’ are not allowed to sell their shares or get loans against their shares without the investor’s consent in the presence of a lock-in clause. Having a carve-out clause for encashing a small portion of equity for emergencies is usually a good idea in case the company does impose a lock-in clause.

Wrapping Up

A term sheet has to be assessed carefully and negotiated even more cautiously to avoid investor dissatisfaction since the preliminary stages of negotiation play a pivotal role in the final agreement. Moreover, the relationship between founders and investors bears more value than the terms and the negotiation process of the term sheet helps define that relationship.

The founders use this period to analyze and negotiate the dilution of their control and shares, whereas investors focus on terms concerned with the longitudinal outcome of this deal. Both parties need to remember that although a term sheet is non-binding, they still enforce confidentiality, exclusivity, and dispute resolution clauses. Early-stage founders must create value for the company in a manner that is either Investor neutral or investor friendly. Additionally, they need to be cautious about the liquidation preferences and exit clauses set by the investors to avoid losing their company in case it doesn’t do well in the market.

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