TERM SHEET EXPLAINED

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Term Sheet is the initial document executed among the investors, (sponsors, entrepreneurs) and the investee company in relation to any investment transaction. Nomenclature varies, with some referring to it as memorandum of understanding or the letter of intent, but the intent is mostly to record the commercial understanding between the parties, which will, subject to due diligence findings, be the basis for the definitive agreements.

Term Sheet is mostly non-binding with the exception of certain provisions: (a) exclusivity (anti shopping); (b) governing law and jurisdiction; (c) drop dead fees; and (d) legal fees.

This article attempts to decode some of the key provisions in a Term Sheet that is issued in early stage to Series A financing rounds. The provisions become complex with multiple investors and in subsequent financing rounds.

Non-Binding / Conditions Precedent

Investors will want the company to offer exclusivity to the transaction for a limited period, and not enter into negotiations with any person regarding the transaction. governing law and jurisdiction provisions are also made binding. Confidentiality of information exchanged between the parties is normally covered by the non-disclosure agreement entered into between the parties, and is not specifically included in the binding provisions. Apart from the exclusivity and governing law provisions, promoters may also be required to provide 'drop dead fees', pre-agreed sum of money, in the event they back out from the transaction for reasons not attributable to the investor. Investor may also want that the company pay for its legal fees whether or not the transaction happens. Drop dead fees and legal fees reimbursement provision is not usual, but comes up every now and then.

Completion of the investment transaction by the investor is subject to the company completing conditions precedent. Term Sheet contains an indicative list of conditions precedent to be completed. These are usually both parties obtaining corporate authorizations necessary for completion of the transaction. Term Sheet would need to be approved by the investment committee of the investor. Therefore, even if the terms in the Term Sheet is agreed, but the investment committee does not approve the transaction based on the information memorandum on the company prepared by the investment manager with inputs from the due diligence exercise, the transaction may fall away. Other standard conditions precedent include: (a) promoters entering into employment agreement, (b) assigning intellectual property in favor of the Company, etc. The list is augmented based on the findings from the due diligence exercise conducted by investor's advisors.

There are 3 important things in a Term Sheet that matter to the investor: Valuation; Control; and Exit.

Valuation / Price

Valuation is determined upfront, but is subject to all assumptions for such determination being true at the completion of the legal, business and tax due diligence.

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Pre-money valuation and post-money valuation are the terms that are mostly used in relation to valuation.

Pre-money valuation is the valuation of the company at the time of the investment; and post-money valuation is the valuation of the company after the investment. For example, if the valuation of a company is USD 1 Million, and the investment amount is USD 1 Million, the post-money valuation would be USD 2 Million.

Investors would mostly want the employees stock option plan (ESOP) to be established, if not already established, or if established, the size of the option pool is not sufficient to attract quality work force or motivate the existing work force. ESOP is always included into the pre-money valuation. The effect of this is that the pre-money valuation is reduced. As a result, promoters shareholding is diluted without dilution to Investor's shareholding. The size of the option pool is negotiated.

Typically, in a pre-Series A round of financing the valuation of the Company is not mostly known or agreed. Discussion of valuation is deferred for a later period and convertible securities are issued. In such cases, the provision on valuation is normally not contained in the Term Sheet.

Conversion

If the investor is subscribing to convertible preference shares or other convertible securities, the Term Sheet will contain detail terms relating to conversion of convertible securities.

There are 3 terms that are used in relation to conversion: floor, cap, and discount.

Convertible instruments are issued because the parties cannot agree on the valuation of the company. Promoters also believe that the valuation of the company on the date of investment does not fully reflect the true value of the company, and that additional 1-2 years is required to realize the efforts and contributions of the promoters. Convertible instruments are normally issued by startups and early stage companies. Convertible instruments convert into equity shares on a future date (mostly future financing event) at a conversion discount to the valuation arrived on such future date. Convertible instruments in early stage financing provide for a discount to the valuation at the next round or Series A financing. Discount is to compensate the investors for the risk taken in investing earlier in the company. The discount rates are higher than the bank rate of interest and is usually negotiated. If the convertibles are issued in mature companies without conversion feature based on valuation at a future date, the sole purpose of convertibles in that case would be to enable LP.

The approximate pre-money valuation of the company on the date of the investment is generally referred to as 'floor valuation'. Convertibles convert into equity shares at the floor valuation if the company fails to achieve the milestones. Floor is favorable to the Promoters that it restricts the conversion price in a bad situation to floor valuation even if the fair value could be lower. With a backstop on valuation, Promoters dilution is limited to the floor valuation in a worst case.

Capped valuation is favorable to the investor in that the company and the promoters agree on the maximum valuation that would be applicable to the convertible instruments regardless of the valuation of the company on the conversion date.

Claw back/ Vesting

Promoter vesting is commonly found in Series A investments. Promoter shareholding is transferred into a notional pool (in certain cases the custody is transferred to an escrow account) and will vest over 3 – 4 years. Promoter will require to be employed or associated with the company during the vesting period for the shares to vest. If the Promoter ceases to be employed during the vesting period (other than for good reasons- that is being terminated for no cause), the shares of the promoter in the notional pool will need to be transferred to other shareholders or the Investor at par value or transferred to employee stock option pool. For example, if the promoter leaves employment after first year, 75% of the unvested shares (on a 4-year vesting) will need to be transferred to other shareholders or employees stock option pool. If the company is in existence for 1 year and over and has made some advancement with the business, the promoters could ask for 25% to vest at the completion of the investment and the balance to vest over 3-4 years. Vesting could be computed monthly or annually.

Vesting could be accelerated if the company is involved in an acquisition transaction or the promoter is terminated by the company for without cause.

Anti-dilution

Anti-dilution provision is included to protect the investor in the event of a down round. If the company issues shares at a price that is lower than the price of Series A (**New Price**), the investor is offered 'Ratchet' or 'Weighted Average' based anti-dilution to protect from economic loss that the Series A investor would suffer from issuance of shares at New Price.

Ratchet (Full Ratchet or Partial Ratchet) means that if the company issues shares at a price that is lower than the Series A, then the price per share of Series A is repriced to the New Price.

In Weighted Average anti-dilution, the number of shares issued at the New Price is considered for repricing the Series A. Entire Series A is not repriced at the New Price. Weighted Average formula has 2 variants: 'broad based' and 'narrow based'. Broadly put, broad based is calculated on fully diluted basis (considering all securities convertible into equity shares), and narrow based considers only the securities of a particular series that is being adjusted.

Anti-dilution provision does not apply to shares reserved to be issued under an employee stock option plan. Options under an employee stock option already included in the pre-money valuation when issued in the future at a price lower than the Series A price is not a dilution to the investor.

Liquidation Preference

Liquidation preference (**LP**) sets forth the order of distribution of liquidation proceeds to the shareholders on occurrence of a liquidation event.

LP is made up of 2 parts: Preference and Participation/ Participating.

If the investor has Preference rights on a liquidation event, investor have preference to receive from the liquidation proceeds an amount equal to its investment amount or the principal before any distribution is made to the equity shareholders. If investor is provided with a right to receive only his original investment amount, investor would have 1x LP. Investor could also be provided with Preference that is multiple times its original investment say, 2x or 3x LP.

If the investor shares are Participating, investor will be entitled to first receive the Preference (i.e., 1x LP, 2x LP etc.) and then participate in the balance liquidation proceeds 'on as converted basis' up to an agreed amount. Participation rights could be to the full extent i.e., to the full extent of the equity shareholding of the Investor resulting upon conversion or could be capped to a certain amount.

Liquidation event is defined to include not just the bad events such as winding up or bankruptcy, but includes trade sale, mergers and acquisitions, and all events of liquidity where proceeds are available for distribution to the shareholders for their equity.

Board of Directors

Control is achieved through representation on the Board of Directors of the Company, and affirmative (veto) rights at the board and the shareholders' meetings. Control provisions are used by the investor to track the operations of the Company, and to ensure that their investment is correctly utilized, and that the decisions of the Company do not affect their rights or the returns. Control rights of the Investor is a mechanism through which the investor vetoes certain decisions of the company. It is usually a negative right and not a positive right through which they affirmatively cause the company to take any actions.

Investor is provided a right to nominate a person on the Board of Directors. The composition of the Board of Directors depends on several factors, including: size and stage of the investment; whether investors from previous rounds also have Board nomination rights, etc. Companies prefer that the size of the Board is not unwieldy, and the Investor nominee has domain knowledge, so that the Company gains from their contributions.

Investors also at times seek for observer rights. Observer is not counted for quorum and does not have voting rights.

If the size of the investment is not significant (pre Series A), Investor is normally not provided with either the right to nominate a Director to the Board of Directors or the veto rights.

Exit (IPO, Buy Back, Drag Along Rights, Tag Along Rights)

Typically, the life of a venture capital / private equity fund is 8 years. Investor will want to exit the investments before the life of the fund ends. Investors define the exit path in the Term Sheet. Exit provisions are not normally contemplated in early stage Term Sheets and are detailed in Series A round of financing.

Exit provisions include: Initial Public Offering (IPO); sale of the company; buy back etc. IPO would be an ideal exit, but IPO is conducted only if it is going to be a success. Buy back requires compliance with certain conditions under the provisions of the Companies Act, 2013. Due to such conditions, the buyback option cannot fully achieve the goals of the Investor, and is not normally pursued.

Exits offered to the investor will have to provide to the investors, a certain rate of return that is specified in the Term Sheet.

If the exit is not provided to the Investor within a certain period, the investor is given the control to drive the exit and compel the shareholders to assist in the transaction elected by the investor. Drag Along Rights is normally provided to the Investors of Series A and onwards. Investor is given a right to require the other shareholders of the company to sell their shareholding to a third party purchaser of the company's shares who has offered to purchase the shares of the investor.

Typically, there is a lock-in on transfer of promoters shareholding. Promoters' shareholding is locked-in until the investor is provided an exit, with the exceptions of transfers to affiliates and relatives of the promoters. If the promoter is permitted to transfer his shareholding for reasons other than those permitted, investor will normally be provided a right to transfer their shareholding to the third party purchaser of the promoters shares on the same terms and conditions that is offered to the promoters.

Apart from the above, the Term Sheet also includes the following provisions: (a) further financing; (b) information and inspection rights available to the investor; (c) investor's transfer rights subject to providing any first offer or first refusal right to the promoters; (d) non-compete undertaking of the promoters; (e) governing law and dispute resolution. Details of the share capital of the company, shareholding pattern, prior to and post completion of the transaction is also included in the Term Sheet.