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GlobalSolve™ Management Services

Term Sheet Basics

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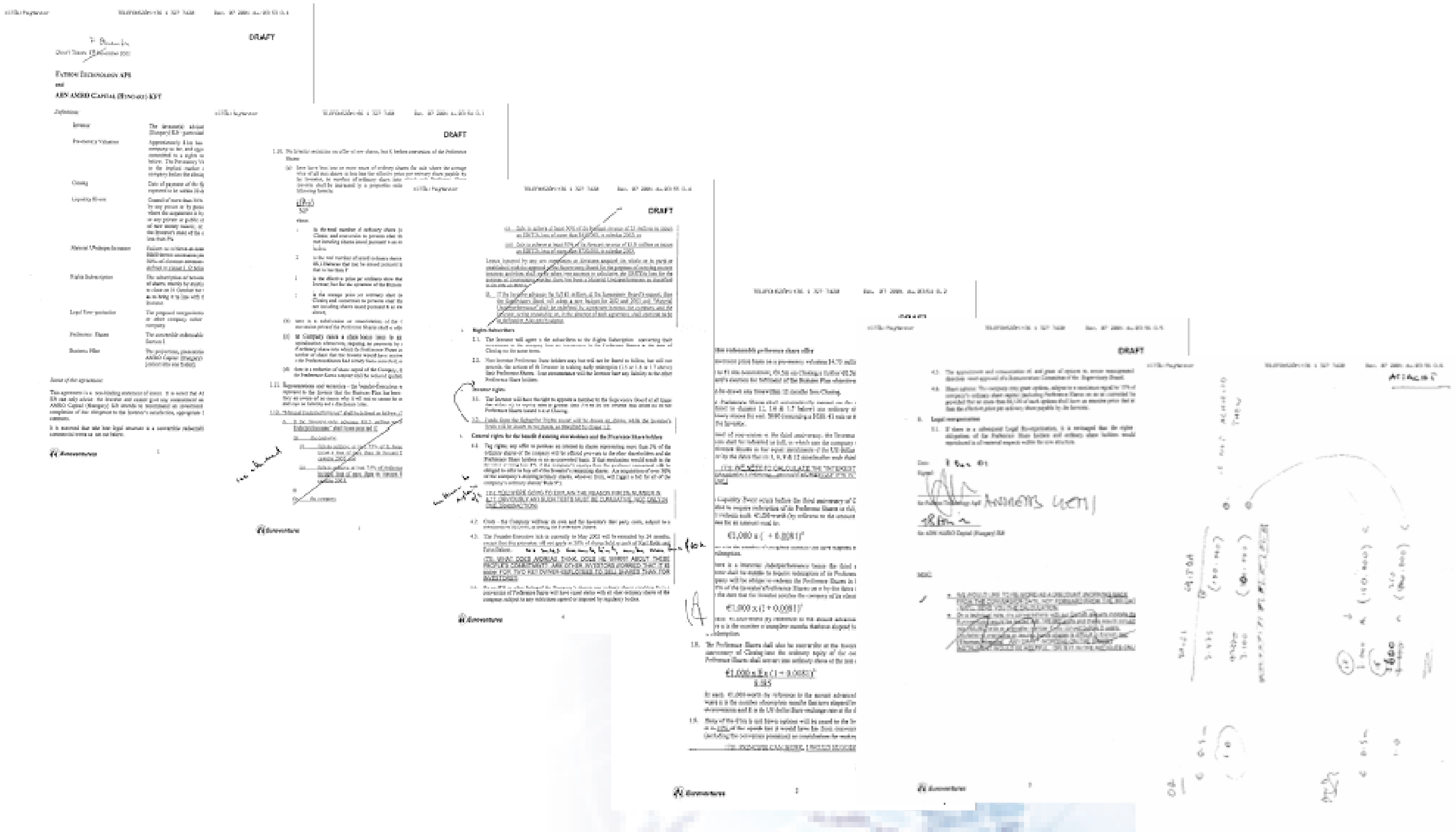
The Role of Term Sheets

Investment process as seen by the Venture Capitalist:

- Initial introduction
- Confidentiality agreement
- Business plan review / "screening"
- Further management meetings, questions
- Term sheet outline
- “Investment profile" / "deal qualifying memorandum"
- **Final term sheet**
- Investment recommendation - approval
- Final documentation, payment
  subscription agreement, shareholders agreement, debt instrument, service contract, option agreement

Sample Term Sheets



Term Sheet

In a transaction, Term Sheets govern

- Value
- Control

Term Sheet Control

Term Sheets govern *control* over

- Capital (cash)
  – To preserve investor capital
- Management
  – To ensure presence of competent and honest management
- Management Decisions
  – To ensure consultation on key decisions
- Information
  – To ensure input for all of the above

Control over Capital

Cash in

- Milestones (internal performance measures)
- "Triggers" (external events)

Cash out

- Expenditures or outlays over certain limits
  - management salaries and other compensation
  - investments
- Money returned to shareholders
  - dividends, share repurchase
  - liquidation proceeds ('liquidation preference')

Control over Capital – cont.

Capital: right to buy, sell or subscribe shares

- *Pre-emptive Rights*: right to participate in a capital increase before third parties can
- *Tag Along (Piggyback) Rights*: right to sell shares pro rata with the selling party
- *Drag Along Rights*: right of one selling party to compel other owners to also sell their shares
- *First Offer (First Refusal) Rights*: the right to be able to be offered shares for purchase before any third party can purchase them
- *Preferred Sale (First Out) Rights*: The right to sell shares before other owners
- *Lock Up Rights:* The right to prevent other owners from selling their shares for a period of time or under certain conditions

Control over Management

- Right to fire CEO, other key managers
- Right to appoint CEO, other key managers
- Constrain job mobility of CEO
  - Termination clauses, duration of contract
  - Non-compete clauses
  - Tenure-based incentives/penalties
    - Share vesting, tenure-based bonuses, ratchets
    - Share repurchase rights (forced sale of shares to investors)
    - Lock-up clauses (prevent sale of shares by management), preferred sale clauses (allows investor to sell shares first)

Control over Mgt. Decisions

Investor Approval for

- Investments, acquisitions, divestitures
- Obligations or expenses over certain limits
- Capital increases, decreases
- Strategy, nature of business
- Budget, use of financing proceeds
- Change in basis or quality of key investor information (accounting methodology)
- Related party transactions (incl. mgt. compensation, loans)

Control over Information

- Regular reporting requirements
  - Usual management reports
- Inspection rights
  - Right of investor to inspect the company in detail at his own discretion
- Designation or approval of auditor
  - To insure financial oversight exercised by neutral or pro-Investor party
- Access to company employees or management meetings
  - Not too common except for start-ups

Type of Control

- **Positive**
  - Investor actively has right to determine a policy or execute a function
    - Example: capital raising, company divestiture
- Negative
  - Investor approval required (veto available) for actions proposed by management
- **Contingent**
  - Investor may gain control subject to certain adverse events
    - ‘Flip over’ clause: flips Board control to Investor

Default Control

- Who is in control of events by default? Investor? Management? Entrepreneur?
- Who has to take some sort of legal or enforcement action to gain control?

Value

- Term sheets also govern the allocation of value in a transaction
  - Nominal Value
  - Contingent Value

Nominal Value

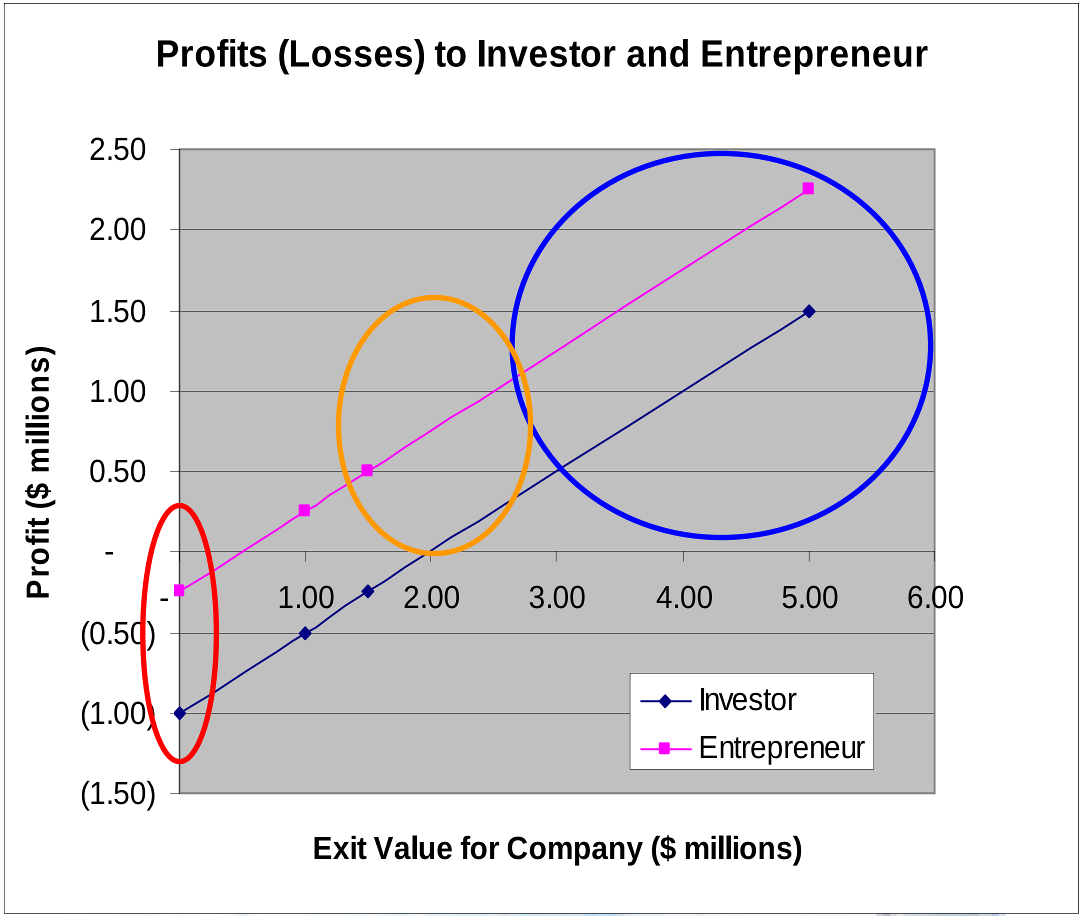
- Nominal or 'headline' value in a deal
  - Ex: "Investor invested $1 million in company for 60% of the equity"
- Strengths
  - simple, transparent, easy for lawyers to package into a transaction document
- Weakness
  - Incentives not properly aligned at low exit values
  - May create 'moral hazard' issue

Nominal Value Example

- Investor Investment: $1 million
- Entrepreneur Cost: $250k (in time and effort, risk-adjusted)
- Pre-Money Value: $1 million
- Post-Money Value: $2 million
- Investor Share of Equity: 50%
- Entrepreneur Share of Equity: 50%

Nominal Value Example

- In this case, the investor is prepared to accept the valuation in the **blue zone.**
- In the **red zone**, all the participants lose all their investment — although the investor loses 4x as much in value as the entrepreneur
- In the **brown zone**, the entrepreneur is actually breaking even or making money — even while the investor is losing money!



Financial Engineering

- To overcome valuation or incentive issues, VC's will engage in "financial engineering"
  - Debt
  - Preferred Shares
  - Preferred Convertible Securities
  - Mixed Debt and Equity
  - Ratchets or "Clawbacks" (Downside for Investor, Upside for Entrepreneur)
  - Liquidation preferences
- Fundamentally challenges notion of pre-money value, as values and returns become contingent on future events

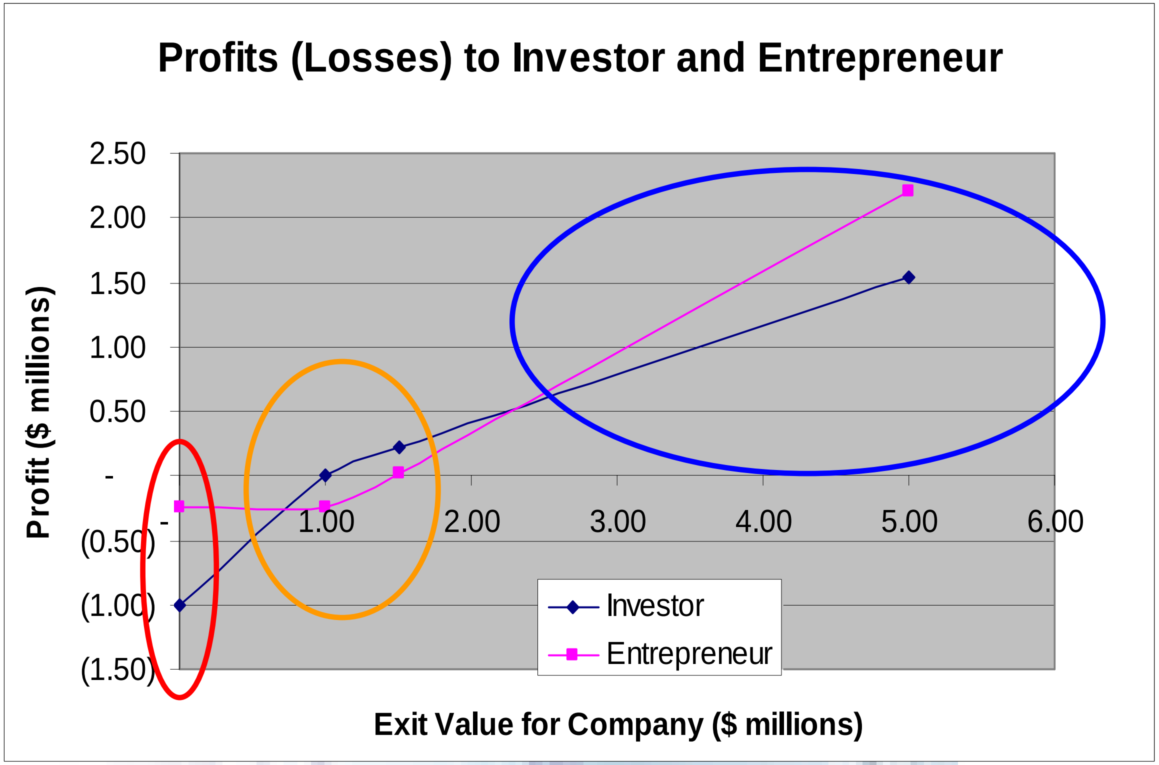
Contingent Value Example

Same Deal as Before:

- Investor invests $1 million
- Entrepreneur Cost: $250k (in time and effort, risk-adjusted)
- New Terms
  - Liquidation preference: Investor is repaid investment before Entrepreneur receives anything
  - Preferred Return to Investor: Split of returns is in investor's favor (60/40) until he receives a base return of 10% return on investment is achieved
  - Returns above this amount are split in the Entrepreneur's favor (40/60)
- At $5 million exit valuation, both parties receive the same returns as in the nominal example.

Contingent Value Example

- As before, the investor is prepared to accept the valuation in the **blue zone.**
- As before, in the **red zone**, all the investors lose all their investment — although the investor loses 4x as much in value as the entrepreneur
- However, now in the **brown zone**, the entrepreneur must repay principal and some return to investor before receiving own return.



Financial & Term Sheet Engineering

Strengths

- Allows customization of deal to unique situation of vc and entrepreneur

Weaknesses

- Time consuming
- Incentive to ‘game the system’ with complexity and tricks
- May require similar level of sophistication from both parties to avoid offense and understand implications
- Can be punishing on legal teams drafting transaction documentation — and therefore expensive
- Complexity may generate unintended consequences in the future and unforeseen openings for ‘moral hazard’ related behavior

Other Terms

REPRESENTATIONS AND WARRANTIES

- *“The Management will give normal representations and warranties”*
  - Accuracy of business plan
  - Accuracy of accounts
  - Good standing of business:
    - Tax
    - Property leases
    - Insurances
    - Obligations / debts
    - Etc.

Other Terms

LEGAL STATUS

Non-binding, except:

- Confidentiality
- Exclusivity
- Costs

Summary

Term Sheets

- Establish the parameters of a deal and the intent of the parties involved
- Require thought and analysis, with a good understanding of the implications of various tools

But –

- Not a substitute for a sound business plan and a good management team
- Not a substitute for good listening skills and a willingness to work with one's partners to achieve a positive outcome for all involved
- Not the same as investment success.