

A Philosophy of Valuation and Term-Sheets

By Tim Keane, Director, Golden Angels Investors, LLC

Entrepreneurs are often not experts in the area of term-sheet negotiations and all of the surrounding issues. Investors sometimes “present” the terms they’d like and expect the entrepreneurs to react. This frequently leads to lots of legal expense just to get to an understanding of what’s being asked for. A lack of understanding can lead to expensive and difficult negotiations when more clarity earlier in the process may have produced a more efficient and less difficult result.

Now that I’m more often on the other side of the term-sheet, I’ve tried to present term-sheets to entrepreneurs accompanied by a philosophical explanation of what I’m proposing, and why.

I’ve sat down with entrepreneurs and a copy of a term sheet guide I like [*“Term Sheets & Valuations - A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations”* by Alex Wilmerding, Aspatore Press.] and walked through each proposed term and why it is or isn’t important. When accompanied by an “output” spreadsheet that shows the results and implications of terms, this often makes the process work pretty well.

This essay is an attempt to replicate some of that thinking.

The Valuation Question

When companies seeking their first round of serious funding are good enough to receive a term-sheet from an investor, the first issue that always arises is valuation.

Good investors use the valuation discussions to gauge the business savvy of the management team and to understand their ability to appreciate and deal with economic market forces that set values. Most often, investors who are interested in a company raise this issue first to measure the company’s response to a market value offer.

The investors and the entrepreneurs are – or should be – aware that the price of the company’s equity is set by the market – in simplest terms, what an informed buyer is willing to pay. As a starting point, these become market comparable discussions based on other similar transactions within a recent timeframe and similar business.

Let’s look at how the investor arrives at a value from a philosophical point

Rev 2 May 2010

of view.

Most often, investors have a return target in mind to help them gauge opportunities. For individual angels and others investing their own money, this may be more fluid than for someone with responsibility for a managed fund. For angel groups, the distinction between groups and VCs on this issue is dwindling, especially as angel groups do bigger rounds of financing.

I've attached a spreadsheet to this article to illustrate the issues in numbers. You can vary both valuation and term-sheet assumptions (in the gray boxes) to assess the impact on the values of the business. Note that this applies only to early stage Series A-type equity financings and assumes no cash dividends are paid to investors. It also assumes the entire value of the investment is captured for investors at a sale of the company in the time specified in the term-sheet.

Let's start at the end. On the last line on page two of the workbook, you see the resulting returns to the entrepreneur with a variety of terms and valuations and assumptions. (Originally the sheet showed that selling at \$118MM yields a return to the entrepreneur of \$73MM).

Now let's go back to the beginning and begin to understand how one might come to this result.

It starts with the return the investor expects, not normally with what the entrepreneur thinks the company is "worth." (Both of these points of view will be tempered by market comparables, i.e., what other willing buyers might pay, but more on that in a moment.)

If you look at the spreadsheet, you will see that the "Required Rate of Return" is expressed as an IRR. Some people will talk about this as a "multiple," i.e., "I expect ten times my investment back." I find this to be imprecise because it doesn't encapsulate the element of time. Internal Rates of Return naturally compound, so a 50% IRR is 7.59 times at 5 years and 11.39 times at six years. (If you plug in an IRR of 58.5% you'll arrive at a multiple of 10 for a five year period.)

Let's work with a five-year horizon. That is, the investor assumption is that the company will be sold in 5 years.

The investors believe they have market opportunities that can meet or exceed their desired IRR of 50% p.a. So, on a \$2MM investment, and a five year horizon, they are expecting a minimum return of \$15.2MM. (7.59 times the investment.)

Rev 2 May 2010

Next, they carefully consider the range of multiples being used *today* to value companies being acquired or doing IPOs in the market that the business is in.

As an example, I have used an EBIT multiple¹ here of 7.65² An EBIT multiple, multiplied by the fifth year EBIT projection, results in an estimate of what the company might sell for in the future *given market conditions as they are today*. In this example, it's 7.65 x \$15.504MM equals \$118.605MM.

Now turn to the company performance projections. Five-year projections, of course, are never accurate. And if they are built from the top down, they're pretty much useless.³ However, if they are built bottom up, they demonstrate and make explicit a range of business model assumptions the entrepreneur is using to think about his business and its revenue model.

This is why a bottom up approach is more credible. In a bottom up approach, the forecast is built from actual user projections. ("If we can close 35% of all opportunities, and can get an opportunity by making x contacts, and there are 300 opportunities per month, then we should be able to sell 100 customers per month if we have the capital (\$35 per contact) to cover the market every month." This results in a five-year projection of XYZ.)

So, after having built a working business model with a bottom up projection, let's assume the five year number in this example is \$91MM in revenue. Let's also assume that the market EBIT is about 16% and the entrepreneur thinks he can do 17%, a not unreasonable expectation.⁴

Now, the investor asks:

- What happens if 5 year EBIT drops from the \$15MM projection to \$5MM?

¹ Various multiples are used for various reasons. Pre-bubble Silicon Valley deals were popularly valued at multiples of revenue. For the sake of this discussion it's the method rather than the specific metric that is important.

² (I don't like EBITDA multiples very much. The EBIT concept is to remove the impact of interest and tax on company profits since financing the purchase and paying tax are issues the acquirer may be able to influence. However, unless you assume that equipment used to run the business will last forever and never need to be replaced, depreciation is a real expense. So I like multiples of EBIT rather than EBITDA.)

³ Top down projections begin with some assumptions about the size of the total served market and then carve out some, usually small, percentage of the market. "The total market is 2BB so if we get 5%, it's \$100MM!". A bottom up approach has the advantage of logic.

⁴ It's beyond the scope of this short essay to get into the issue of the disruptive nature of the business. However, I assume that the proposed business solves a real problem that people are willing to pay for and that it may be least costly, more efficient, and IP-protected.

Rev 2 May 2010

- What happens if the EBIT %age erodes from 17% to 12%?
- What happens if the projected growth rate declines more rapidly than projected?

A simple way to model this is to reduce both EBIT projections and the market multiple to project terminal values.⁵

This results in a range of sale prices; in this example from \$118.6MM to \$21MM. Note that the “reductions” in this worksheet are only examples for illustrative purposes and are not necessarily normative.

An average of these ranges results in a pre-money valuation of about \$4MM. (\$2mm invested divided by an average % ownership required to me the investor’s target of 33%).

Next, the investor considers the current M&A market conditions. If similarly situated companies are seeing \$3.5MM pre-money valuations, this might become the target valuation.

Why, you ask, waste all of your time cranking through all of this only to arrive at a value based on comparable transactions?

First of all, both parties ought to be mindful of M&A market values. If the entrepreneur has two competing offers, that’s an excellent way to understand what the market will pay. Market comparables represent the other way.

Secondly, if the result of the analysis yielded a valuation that only worked at the top of the range, (i.e., the highest value for the company translated to the M&A market comparable and the other scenarios were less) the investor would have to either really understand why or simply walk away. So M&A market comparables cannot, in the investors mind, be a substitute for doing the work.⁶

⁵ *Reducing EBIT projections is largely an internal discussion while the idea of looking at reduced multiples for smaller EBITs may be available in the marketplace, especially to sophisticated investors.*

⁶ *Both parties should be aware that overpaying by investors can be a sign of trouble. If a company has two or three competing offers and one stands out as being 35% higher than the other(s), it is important for the company to really understand why that is. One possibility is that the investor has an especially informed view of the market and will be able to actively help the company achieve outstanding results. This should be relatively simple for the entrepreneur to assess based on the references and prior activities of the investor. (Of course, savvy entrepreneurial teams always check those!) Another possibility is that the investors is inexperienced and is overly reliant on the entrepreneur’s presentation. An inexperienced investor, when things don’t go perfectly according to plan, can be very unhappy. And depending upon how much future control they acquired in the term-sheet, it is possible that they can make a future financing exceedingly difficult. In my experience, overpayment is most often the second case rather than the first.*

Rev 2 May 2010

After all of this, in this example, all parties agree on a pre-money valuation of \$3.5MM and a \$2MM investment, giving the investor a 33.2% stake in the company.

The Consideration of Risk

It is logical to ask why a Term Sheet contains all kinds of complexities if everyone has agreed upon the valuation discussed above. The answer to that, in a word, is *risk*, - the uncertainty of outcome. Term-sheets for preferred stock offerings are designed to protect the investor in case things don't go as well as planned.

Investors want to protect their investment in the company by using tools that help assure that, in a less successful situation, they can still achieve some or all of their goals. If entrepreneurs believe that they can achieve the projected results, they will generally feel comfortable by accepting terms that reduce the *investors perception* of risk. For an entrepreneur the best situation is to be able to gladly assent to these risk-reducing terms if he knows the venture will be successful enough that they will not really be important. Investors generally will really like that approach.

Entrepreneurs should be aware of this and negotiate terms accordingly.

At the financial level, and assuming a harvest of the investment in the company without the need for further financing, two terms stand out as driving economics: the dividend and the liquidation preference.

First, *dividends*. The risk-protection sense of a dividend is that the invested money makes some interest-like return, which makes it more likely the investor will receive some modest amount of earnings in the event the company doesn't do well. In some cases, dividends are often paid at the discretion of the board and not required by the terms.

Dividends come in two basic flavors – cumulative and non-cumulative. A cumulative dividend compounds annually.

In the example on the spreadsheet, a cumulative 8% dividend paid every year for five years pays \$938,000 while a non-cumulative dividend pays about \$800,000. A cumulative dividend can get to be very expensive and is not often a feature in early stage terms. Dividends, finally, are normally not paid in cash; they are accrued and paid at the sale of the company, if they have been declared each year by the board. Some dividends are not required to be paid annually unless the board does declare them. Since

preferred dividends are paid before common dividends, these provisions often have the effect of preventing payment of dividends to anyone, which is usually what the investors would like. This keeps the cash working in the company rather than being paid out to stockholders.

Most investors aren't focused on dividends, and I see very few cumulative dividend term-sheets. So, let's assume here we have an 8% non-cumulative annual dividend paid only to the preferred.

In some rare cases, there may also be a participation provision for dividends which pays the preferred a dividend beyond their own equal to any dividend paid to the common. It is very expensive if you're the entrepreneur since it doubles the cost to the company of paying dividends to the entrepreneur. I've never seen it in practice.

Second a liquidation preference and a participation.

A liquidation preference means that the investors receive their investment back (plus dividends) prior to a distribution of the proceeds to stockholders.

The risk-reduction feature here is that the investor receives all of his money back before the entrepreneur receives anything. Why is this fair? Say I invest \$1MM in a company and receive 40% of the stock. After some time, it becomes evident the company is never going to be really successful, and a larger player in the market offers to buy the company for \$2MM. With a preference, I get \$1MM back and then the remaining proceeds are divided so I would receive \$1.4MM out of \$2MM. If the entrepreneur doesn't feel this kind of result is feasible because he/she will move mountains to achieve outstanding results, they shouldn't care about this very much.

The investor may also ask for a participation in which the investors receive some additional multiple of their investment prior to distribution of proceeds to stockholders. So, for instance, the investor in the above example with a 1x participation (a pretty common term these days) would get \$2MM – the original investment back and 1x that investment in addition – before the entrepreneur receives anything. Again, the feature of this is that it reduces investor risk and requires some level of achievement before the entrepreneur is ultimately rewarded.

On page two of the spreadsheet, you can see the result of dividends, liquidation preferences, and participation terms.

You can see how these affect the harvest proceeds and investor multiples

Rev 2 May 2010

achieved at various levels.

Non-financial terms affecting Risk

Other major term-sheet provisions, in addition to these economic considerations, also focus on reducing investor risk.

These include:

- **A “put right.”** This gives the investor the right to require the company to buy back the investor’s stock at a predetermined price or a market appraisal value, after a certain amount of time has passed. For instance, if the entrepreneur asserts that the company can be sold in three years, and the investors are in agreement, the investor may ask for a put right beginning after 36 months. This allows the investor the option to require the company to take action to purchase the investor’s shares.
- **Vesting of Founder Stock.** Especially in situations where the founders have a large position and are key employees, it is not uncommon for investors to request that they agree to have some portion of their holdings vest on a schedule. This is perceived by some investors as a way to assure that the founders are in the game for the long run.
- **Conversion provisions** allowing preferred to convert to common if they choose or upon the closing of an IPO at a specified price. This is most commonly used when a conversion confers superior economic benefits on the preferred stockholder.
- **Anti-dilution provisions** that reduce the price of the preferred shares (using a variety of formulas) in the event that the company issues new stock at a lower price. A full ratchet anti-dilution clause is very unfriendly to entrepreneurs; it requires them to make up the entire difference in price from their own holdings. Weighted average methods tend to spread the pain of dilution over all of the existing stockholders using a variety of “weighted” methods. Pay to play provisions are often found here which specify that an investor loses their anti dilution rights if they do not buy their pro-rata share of a new offering.
- **Voting rights.** Preferred vote their shares “as if converted” to common so that they exercise substantial voting control over items requiring stockholder votes.

- **Protective provisions.** These confer certain veto rights upon the preferred holders that restrict the company's ability to take action adverse to the preferred without their consent.
- **Board composition.** Boards of directors have specific duties and voting rights – things like appointing officers of the company, overseeing financial matters, and so forth. A savvy investor will look for a company that has an orientation to outside, impartial directors. This typically indicates a management team that understands the value of outside directors as a way of strengthening the company. Investors will want to have a seat at the table. Oftentimes, term-sheets specify provisions under which there is not a majority on the board from either founders or investors. Sometimes investors will also ask for observation rights so that they may bring expertise to the board without necessarily requiring more voting seats than would be practical.
- **Registration and demand rights** are provisions that require a company to file for an IPO under certain circumstances.
- **Right of First Refusal** confers on the preferred investor the right to purchase either all of or their pro-rata share of future offerings in the event of a future financing. The right of first refusal for all of a future financing is a very unfriendly provision to entrepreneurs that can make future financing all but impossible. It essentially gives the investor the right to take all of a future offering, which means that no new investor will consider spending the time to make a deal knowing that the existing investor can walk away with it.
- **Conditions Precedent** mean that the closing of the proposed offering is subject to the conditions specified here. This can often include due diligence review of technology and intellectual property; execution of employment and invention agreements; agreement on definitive documents, and so forth.
- **Other items** often include the creation of an employee stock option pool prior to closing; restrictions on sales of common stock to third parties; key man insurance, and D&O liability insurance provisions, among others.

Seen from a 35,000-foot vantage point, term-sheets and valuations are a method of assessing risk and making mutual promises about assuming various risk components.

My own practice, as I mentioned at the beginning of this note, in

Rev 2 May 2010

negotiating term-sheets is to build a real version of the attached theoretical spreadsheet, and sit down with the entrepreneur, the spreadsheet and a copy of *“Term Sheets & Valuations - A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations”* by Alex Wilmerding, Aspatore Press.

Once we can all agree on the principles of risk and its management, I find it relatively easier to discuss the other terms in the term-sheet. Wilmerding lays out investor-friendly, entrepreneur-friendly, and neutral terms in an easy to understand way. I personally find the process of negotiating to be much easier to agree if both parties understand the meaning of the terms at the time they talk about them.

A Word About Alignment of Interests

It’s almost impossible for this process not to take on the characteristics of competitive tennis (or insert your favorite competitive analogy here) in which it naturally seems that one side has to win some points *from the other side* to somehow feel good about having achieved something.

Another way to think about this is for both sides to offer up terms that support their assertions in a positive, meaningful way. For example:

- If the investor says “we are very interested in supporting this company for the long term, assuming we all make progress as agreed,” then pay to play provisions make some sense.
- If the entrepreneur says “the value of this company will never go down,” then a full ratchet anti-dilution provision certainly backs that up.
- If both parties are in agreement that this is not a lifestyle business and will be sold in some specified period of time, like three to five years, then a put provision at or beyond that time, at fair market value or some other agreed to formula, seems reasonable.

When both parties can agree on the “why” behind the terms, incentives are aligned and the chance for this being a successful team effort between entrepreneurs and investors is much higher.