



Aspen Network of Development Entrepreneurs



ANDE is a global network that supports entrepreneurs



Provide financial, educational & business support services to small & growing businesses

More than 175 members across 150 countries

- **Investors**
- **Capacity development providers**
- **Research & academic institutions**
- **Development finance institutions**
- **Corporations**

Dedicated East Africa chapter

ANDE's Legal Working Group encourages collaboration



Aspen Network of
Development Entrepreneurs

CREATED BY THE ANDE LEGAL WORKING GROUP

Current initiatives:

- Annotated agreements
- Local counsel resources
- Guidelines to develop Code of Ethics
- East Africa Tools

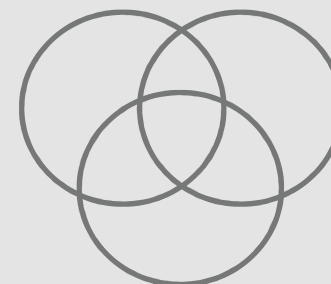
Many others underway!

Global Reach



Interdisciplinary

Investors **Sectors**



**Capacity
Developers**



Aspen Network of
Development Entrepreneurs

We developed tools together with peer review



1

Interview with key stakeholders

- Identify common challenges
- Discuss lessons learned

2

Developed draft documents

- Collaboration among industry stakeholders

3

Peer review: local & global feedback

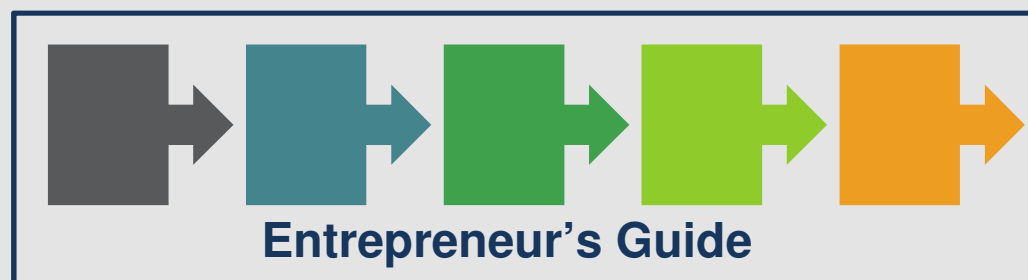
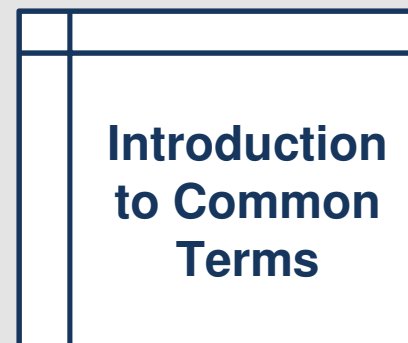
- Through Legal Working Group
- Seeking East African reviewers



Aspen Network of
Development Entrepreneurs

CREATED BY THE ANDE LEGAL WORKING GROUP

East Africa tools framed for multiple audiences



Entrepreneur's Introduction to Term Sheets

October 2013



Aspen Network of
Development Entrepreneurs

Table of Contents



Overview of typical negotiation process

Summary of important terms

Additional resources

Executive summary



The term sheet is a preliminary agreement with your investors after the preliminary meetings and due diligence but before the final deal is signed

- This is generally not binding, but helps move the deal forward
- It creates some formal structure as you move through the negotiations

There are several common terms that investors will push for in order to protect their investment

- e.g. Veto rights, Tag-along rights, or anti-dilution provisions
- These are fairly common, and may be necessary to make an investor comfortable
- But you do have negotiating power, so it is important to understand how to best protect the value of your own stake!

Generally, investors want some degree of control over their investment, which they will try and establish in several ways

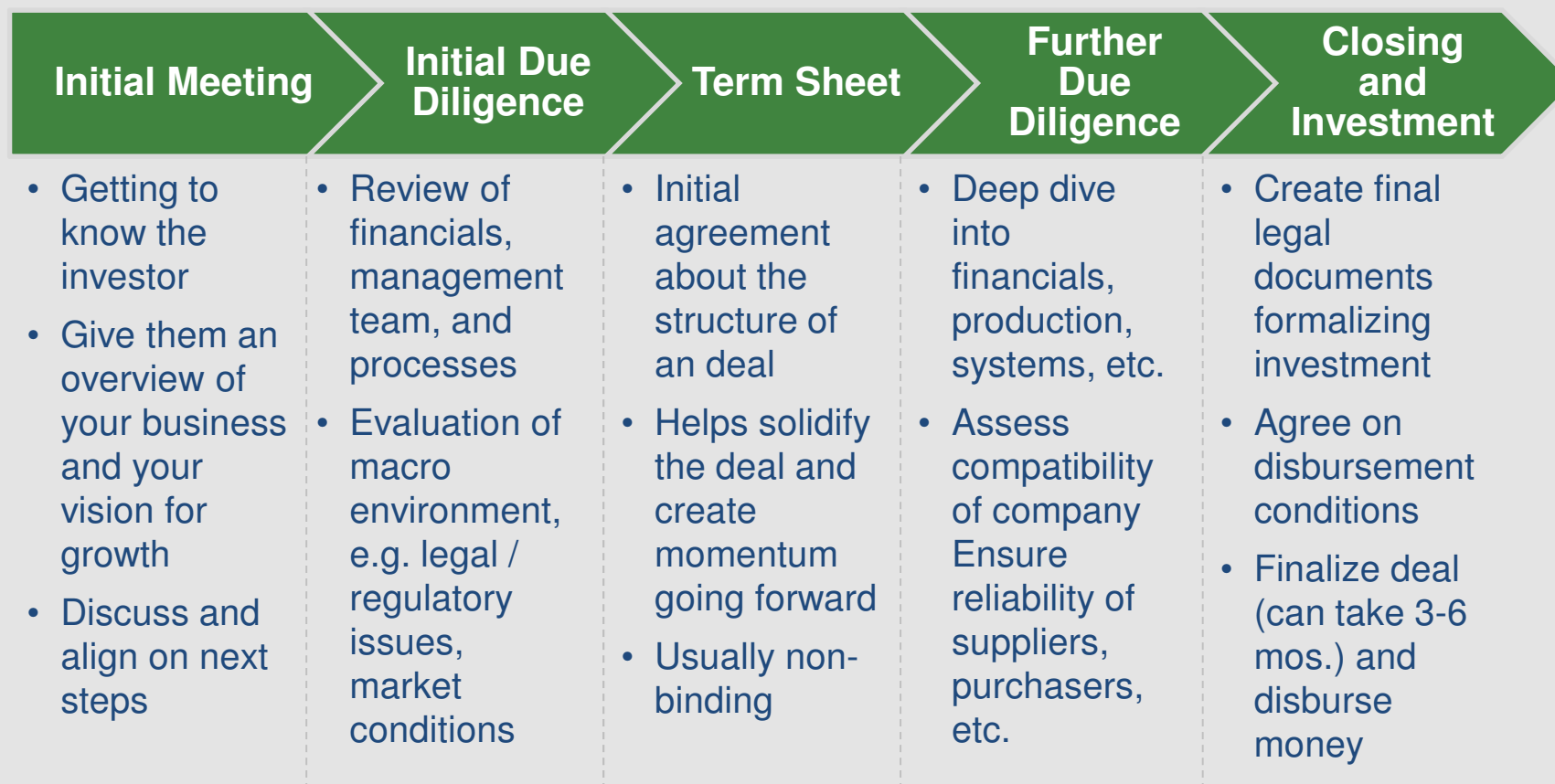
- Board representation: having 1+ seat on the board; defining the board structure
- Shareholder rights: having preferred, voting shares

There are many resources available for entrepreneurs going through their 1st (or 5th!) negotiation



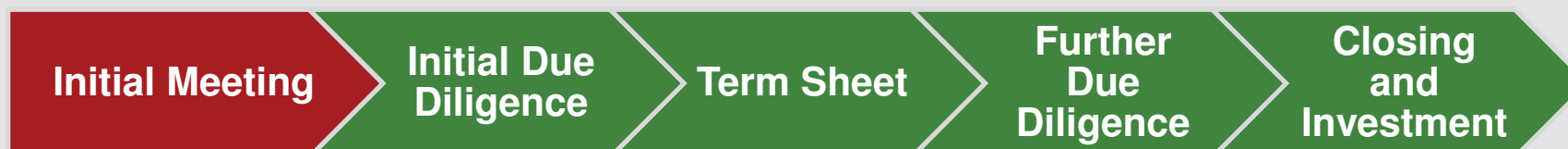
Typical negotiation process

Investors go through standard steps before they are comfortable investing



These interactions will shape the relationship you have with your investor on an on-going basis

Term sheets formalize the negotiation during an investment



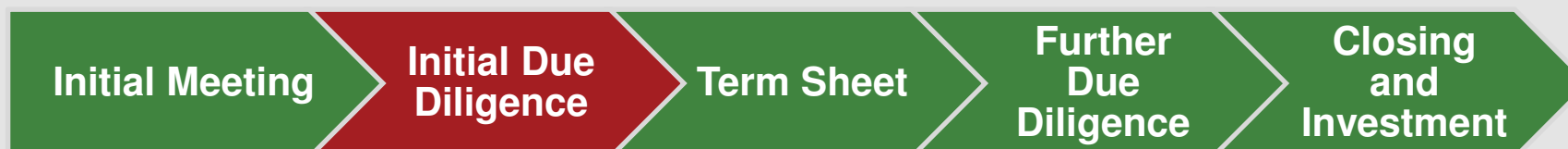
What to expect:

- Investors will want to understand whether you have an idea or a proven model
- They will dig into the experience of your management team, your company's performance thus far, and how you would use the capital they inject into the company

Important meeting outcomes

- **Investor fit:** Is this kind of investor right for you? Does their mission match that of your company? Are you comfortable with their expectations around control?
- **Next steps:** Develop clear next steps to assess whether or not you want to move forward with the process.

Term sheets formalize the negotiation during an investment



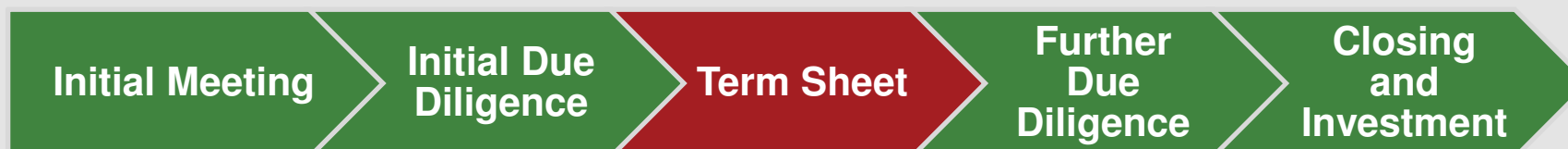
What to expect:

- You will need to start handing over internal documents to the investors so that they can vet what you're telling them – do you have consistent suppliers? Are there unexpected fluctuations in the financials? Etc.
- Be ready to answer questions promptly and thoroughly

Things to consider

- ***Disclosure / confidentiality agreements:*** Do you need to set up an agreement with the investor at this point to protect your proprietary information?
- ***Prepare your systems before you start the process:*** Do some prep work to get your books in order before inviting investors in.

Term sheets formalize the negotiation during an investment



What to expect:

- Negotiations about the level of control the investor will have over your company
- Discussions about the terms the investor will receive
- Starting to formalize your discussions into a written document (though it is generally non-binding!)

Two Important Types to Negotiate

- **Commercial:** the return that the investors will get; how the profits pie gets split between investor and company
- **Control:** mechanisms that allow the investor to exercise control over the business; veto decisions; manage direction of business

Backup: Two possible control mechanisms – Board vs. Shareholders



Every company in Kenya must have a Board of Directors

- Minimum 2 Directors
- Directors do not necessarily need to own shares

Each company decides what will be voted by the Board vs. Shareholders

- Board votes usually taken as a majority of Board members
- Shareholder votes usually as a majority of shares owned
- Either can be reset to two-thirds or three-fourths in support instead of majority

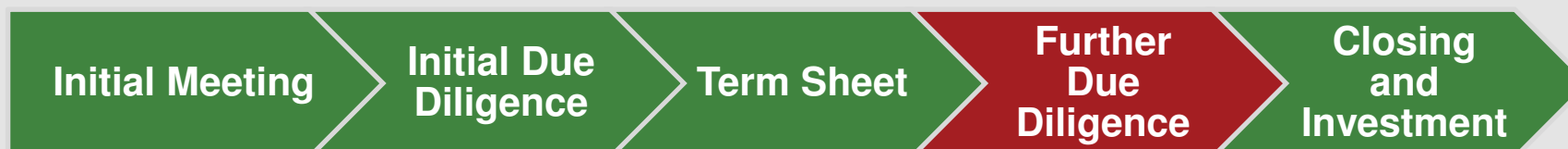
Most Investors will want at least one Board seat

- They will want important decisions to be made by the Board
- They will want to be part of these decisions
- They often have a different voice & experience to add to your decision-making

A Board of Directors clause sets the size and composition of board of directors

- Investor usually wants some kind of representation
- Preferred A who holds X% of stock can elect a board member

Term sheets formalize the negotiation during an investment



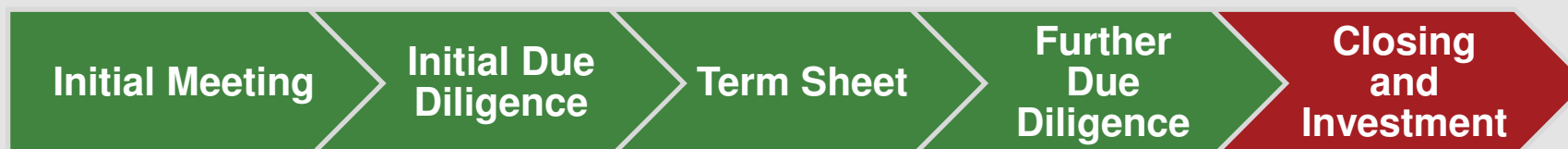
What to expect:

- Very intensive investigations into your internal documents and processes
- Be prepared to answer extensive questions about your past and future performance

Tips for surviving diligence

- ***Expectation management:*** This will take up a large portion of your CFO / finance person's time – make sure they are ready!
- ***Be aware of valuation impact:*** What the investors discover will affect the commercial terms – make sure you can get them current, accurate info.

Term sheets formalize the negotiation during an investment



What to expect:

- A fairly lengthy process as the legal documents are drawn up and finalized
- Time for the investor's own management / board to approve the investment
- At least a few months between their commitment and when you receive money

Suggestions to speed closing

- ***Review and sign documents promptly:*** There will be enough hold-ups on the investor side; make sure that you complete any tasks on your side promptly
- ***Hire local counsel:*** Ensure that you understand the contract provisions and that the contract is locally enforceable.



Important terms to negotiate

Liquidation preference gives the investor an advantage in a “bad case”



Liquidation Preference: *The Investor shall receive X before the Common Shareholders*

Preference has two components

What is a “bad case”?

- Need to agree when this clause would kick in
- Some common examples include bankruptcy, really missing targets, court cases

What does the Investor get?

- Need to agree what is be on the table if the “bad case” happens
- Common examples include an additional amount per share, a fixed \$\$ amount

Participation preference dictates how much Investor can participate in normal stock



Participation preference: Determines the extent to which investors can convert shares and still participate in common stock asset distributions

Why?

Let's say you are a preferred investor in your friend's company. You don't want to lose that position, but you want to benefit from the company's common stock dividend payments.

This may give investors a more advantageous position – they can both ensure a minimum payout and have a large cut of any upside.

Capped participation is a compromise position

Veto rights protect investor interests by giving them power to reject certain decisions



Protective Provisions: *The Investor must approve any:*

- 1) *Merger*
- 2) *Recapitalization*
- 3) *Increase or decrease in Shares*
- 4) *Change in the rights for current Shares*
- 5) *New debt over X amount*

Why?

Let's say you own 20% of your friend's company. He now wants to double the number of shares.

How do you feel? Why?

When you have multiple Investors, good to change this so a majority must agree

This prevents the minority from having too much control

Tag-along rights lets the investor sell with other shareholders



Tag-along right: The Investor can sell shares alongside any shareholder – so if anyone else sells any shares, the Investor can sell

Why?

Let's say you own 20% of your friend's company. He now wants to sell his entire stake, but not let you sell anything.

How do you feel?

Good to negotiate for a pro-rata basis – i.e., if you sell half your shares, the Investor can sell half

Typical for Investors to put something like this in

Drag-along right means the majority can force the minority to sell



Drag-along right: If the majority of Shareholders want to sell, they can force all other shareholder to sell with them at the same price

Why?

Let's say you own 60% of your friend's company and he owns 30%. You're both excited about a great bid you received to buy the company, but the owners of the remaining 10% of shares are refusing to sell.

How do you feel?

Typically negotiated in parallel with Tag-along – i.e., if the majority want to sell, then they have the right

This ensures that no small minority can hold up a sale of the company



Anti-dilution provision protects the investor from losing value in future stock issues



Anti-Dilution: *Used to protect investors in event company issues more stock at lower valuation than previously*

Why?

Let's say you invested in a company at \$10 per share. A year later they issue additional stock at \$5 per share.

How do you feel?

Two options:

Full ratchet – allows the investor to get new, lower-priced shares in the full amount of his / her initial investment

Weighted average – between the initial and the new price; protects interests of founders and employees

Pay-to-play incentivizes existing investors to contribute to future rounds of financing



Pay to Play: *In a new round of financing, if previous Preferred holders does not participate in financing (buying more stock), their preferred stock gets converted to common stock*

Why?

This is a company-friendly provision to help you get future rounds of financing.

It can also help assure investors that the other investors are committed to company success and will invest behind it in the long-term.

This can be a good way to align on expectations between the company and the investors in terms of long-term support.



Right of first refusal gives the investor the first chance at any new stock offerings or sales



Right of First Refusal: *Investor gets right to buy up stock first before Company offers it to third party*

Why?

Let's say you invested early in a company that has grown enormously. They want to sell a 25% stake, and offer it first to a competing investor.

How do you feel?

Can negotiate:

- A threshold for percentage of shares held to qualify for right of first refusal
- Limits on the total number of shares an investor can purchase





Additional resources

Additional Resources



Brad Feld's Term Sheet Series

<http://www.feld.com/wp/archives/2005/08/term-sheet-series-wrap-up.html>

Great series of term sheet explanations written in plain English from a VC perspective

Model Annotated Term Sheets

The International Transactions Clinic at the University of Michigan Law School is developing annotated term sheets for entrepreneurs & investors to use

ANDE Legal Work Group Tools

The ANDE Legal Working Group has collected a number of tools including an overall Legal Guide to East Africa, an Investor's Guide to Terms in East Africa, and is currently working on a project exploring Legal Challenges faced by Women in East Africa

All available online