Pillar Legal Tech Law Blog[1]
Series A Term Sheet
Let's Talk About Valuation

You've raised some funds with SAFEs from friends, family, and angel investors. You've revised your original company slide deck. You've reached out to, talked with, and pitched to far more venture capital funds and other potential investors than you can count. Then, finally, it happens, you receive a term sheet. Hurray! Now what?

Series A Term Sheet Walk Through.

In a string of posts, we will walk through the key deal points from a typical Series A financing term sheet. These posts will track the National ***Venture Capital*** Association ("NVCA") Enhanced Model Term Sheet v3.0, which you can find here. The first thing you might notice is that the source of this term sheet isn't the National ***Founders*** Association. That's right, the industry standard document is produced by the investors, not by the founders, and thus you can imagine which side the terms generally favor.

Although an internet search will turnup some "founder friendly" Series A term sheets like the one page version from Y Combinator, nothing on the founder side has been adopted as broadly or referred to as often as the NVCA forms. Also, the investors will generally present a term sheet to you the founder, not the other way around – so these posts will focus on the NVCA form.

The Philosophy of Term Sheets.

A few words about term sheets.

First, why do we use them? Because they are short. It is much easier to discuss key deal terms on the NVCA term sheet (approximately 15 pages in raw form with explanatory footnotes) than on the definitive NVCA long form deal documents (over 200 pages on the same basis). Some investors have whittled their form term sheet down to a single page – even better.

Second, term sheets (should) say they are not legally binding. Does that mean it isn't important? Absolutely not. Generally, the most important deal points are decided at the term sheet stage. If you try to change things later, that is a re-trade and won't be well received (understatement). So, you should involve your advisors (i.e. lawyers), right now at the term sheet stage.

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Last, consider involving all stakeholders with approval authority at the term sheet stage. Who does this include? Anyone whose consent is needed to close the transaction. That, of course, includes the new investors and the founders, but it might also include current investors that will need to sign the new investment documents, such as current stockholders or holders of convertible notes that for some reason don't convert automatically. Why? When thoughtful existing investors review, and perhaps even sign, the term sheet, if they later try to change things you can call that a re-trade. That might help you avoid an endless cycle of multi-lateral negotiations with each investor taking bite after bite out of the founders most favored nation style.

Let's Talk About Valuation.

The most important number in the term sheet is, of course, the valuation. This represents what your company is worth "on paper" at closing. This one number, together with the investment amount, defines the investor ownership percentage, founder ownership percentage (mostly – see below), the terms for converting SAFEs and convertible notes (if converting at a discount rather than a valuation cap). Thus, this one number is the knife that divides up the current pie, making clear who gets what slice.

This sounds simple enough, just run the math, see where the valuation knife cuts and everything is clear, right? This is generally true, but there are a few special terms to focus on.

Dilution Not Transfers.

When a new investor puts money into a company and receives stock, that stock is newly created stock that is issued by the company. It is not pre-existing stock transferred from current stockholders to the new investor. As a result, when the new stock is created and issued, all existing stockholders are diluted, meaning that they continue to hold the same amount of stock that they did before (nothing is taken away), but their percentage ownership of the company decreases.

Pre-Money, Post-Money, Who's Money?

Valuation is often expressed on a pre-money basis or on a post-money basis.

- Pre-Money Valuation means the value of the company BEFORE investor funds are added.
- Post-Money Valuation means the value of the company AFTER investor funds are added. Thus, it is equal to the Pre-Money Valuation PLUS the investor money.

For example, if a company's pre-money valuation is $9 million, and the new investor puts in $1m, then the post-money valuation will be $10 million. Below please find the pre-closing/pre-money and post-closing/post-money cap table.

	Pre-Closing		Post-Closing	
Founders	8,000,000	100%	8,000,000	90%
Investors	0	0%	888,889	10%
Total	8,000,000	100%	8,888,889	100%

The founder's equity is thus valued at $9 million, which is equal to the founder's post-closing 90% interest multiplied by the $10 million post-money valuation.

Term Sheet Valuation Clause.

Below is a copy/paste of the pre-money valuation clause from the NVCA term sheet.

Pre-Money Valuation:	The price per share of the Series A Preferred (the "Original Purchase Price") shall be the price determined on the basis of a fully-diluted pre-money valuation of [$___] (which pre-money valuation shall include an employee option pool representing [___]% of the fully-diluted post-money capitalization) and a fully-diluted post-money capitalization of [$____].

ESOP Pool and Valuation of Founder Equity.

The NVCA form mentions inclusion of an employee option pool, often called an employee stock option plan ("ESOP") pool, representing a negotiable percent of the post-money valuation. This is a fancy way of saying that the option pool will dilute only the founders and any other current stockholders, but not the new investors.

Using our example above of a $9 million pre-money valuation and a $1 million investment, if we add in a 10% ESOP pool our cap table would look like below.

	Pre-Closing		Create ESOP		Post-Closing	
Founders	8,000,000	100%	8,000,000	88.9%	8,000,000	80%
ESOP	0	0%	1,000,000	11.1%	1,000,000	10%
Investors	0	0%	0	0%	1,000,000	10%
Total	8,000,000	100%	9,000,000	100%	10,000,000	100%

The inclusion of the 10% employee option pool into the pre-money valuation calculation effectively dilutes the founders from 90% ownership down to 80% ownership on a post-money basis. In other words, the entire employee option pool comes from the founder's equity stake, thereby reducing the valuation of the founders' stake from $9 million to approximately $8 million.

What Does Fully-Diluted Mean?

The NVCA form also refers to the pre-money valuation and the post-money valuation being on a fully-diluted basis, which generally means including in the calculation all SAFEs, convertible notes and any other convertible instruments.

For example, if the company had raised $500,000 on SAFEs with a $5 million post-money valuation cap (see our article here on SAFEs for conversion discussion) then the cap table would adjust as follows.

	Pre-Closing		Create ESOP; Convert SAFEs		Post-Closing	
Founders	8,000,000	100%	8,000,000	80%	8,000,000	72%
ESOP	0	0%	1,000,000	10%	1,000,000	9%
SAFEs	0	0%	1,000,000	10%	1,000,000	9%
Investors	0	0%	0	0%	1,111,111	10%
Total	8,000,000	100%	10,000,000	100%	11,111,111	100%

Conversion of the SAFEs before closing the financing round further dilutes the founders, reducing the valuation of the founders' stake to $7.2 million. The new investors, by contrast, are not diluted by the pre-existing SAFE, and they continue to hold 10% of the company post-closing.

Key Takeaways.

- Term sheets say non-binding, but you can't change the agreed terms later, so get your advisors involved at the term sheet stage, if not earlier.
- Prepare a cap table at the term sheet stage to ensure company valuation, ownership interests and founder equity valuation is clear.

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