Translating the Term Sheet (*Entrepreneur Magazine* – August 20, 2001)

Raising capital for your business raises lots of issues, everything from debt vs. equity financing to company valuation to negotiations. Lately, readers have been asking me where a "term sheet" fits into this. In simple terms, a term sheet is a funding offer from a capital provider. It lays out the amount of an investment and the conditions under which the investors expect you to work using their money. The key is to remember that it's just an offer, and the entrepreneur can counter that offer and negotiate all the terms before finally accepting the funds.

The first page of the term sheet states the dollar amount offered and the form of the funds (a bond, common stock, preferred stock, a promissory note or a combination of these). A price, either per $1,000 unit of debt or per share of stock, is quoted to set the cost basis for investors "getting in" on your company. Later in the life of your venture, that starting price will be very important in deciding capital gains and any taxes due at acquisition, IPO or shares/units transferred.

Another key component of the term sheet is the "post-closing capitalization." That is the proposed dollar value of the venture on the day the terms are accepted. For example, investors may offer $500,000 in Series A preferred stock at 50 cents per share (1 million shares) with a post-closing cap of $2 million. This translates into a 25 percent ownership stake in the firm ($500,000 divided by $2 million).

The next section of the term sheet is typically a table that summarizes the entire capital structure of your company. For example, the founding entrepreneur (or team) is listed with his/her (their) shares (common and/or preferred) and the relative percentage ownership stakes for all parties. Investors generally start with preferred stock in order to gain a priority of distribution, should the enterprise fail and the liquidation of assets occur. The typical way to handle this is to have the preferred stock be convertible into common stock on a 1:1 ratio at the investors' option, such that the preferred position is essentially a common stock position, but with priority of repayment over the founders' own common-stock position.

The term sheet then outlines procedures for redemption of preferred stock into common, the conversion schedules (perhaps four to five years), provisions to guard against dilution of the investors' positions, voting rights and other "protective provisions" (to guard ownership-proportionate shares). Investors will also want "information rights" so that the venture will promise to deliver unaudited quarterly financial statements and audited annual statements (balance sheet and income statement) to inform investors of company activities. The final key sections will include terms outlining selection of the board of directors and officers, insurance for directors, officers and senior managers.

Of course, there can always be other terms included on the sheet, regarding rents, equipment, levels of debt vs. equity, minimum and maximum time periods associated with the transfer of shares, vesting in additional shares, and option periods for making subsequent investments and having "right of first refusal" when other rounds of funding are sought in the future. The bottom line on term sheets is this: Get everything stated clearly and definitively at the front end so that future operations and subsequent transactions can work smoothly at the back end as you successfully ramp up your business. The term sheet becomes a great road map for funding your venture today and in the years to come.