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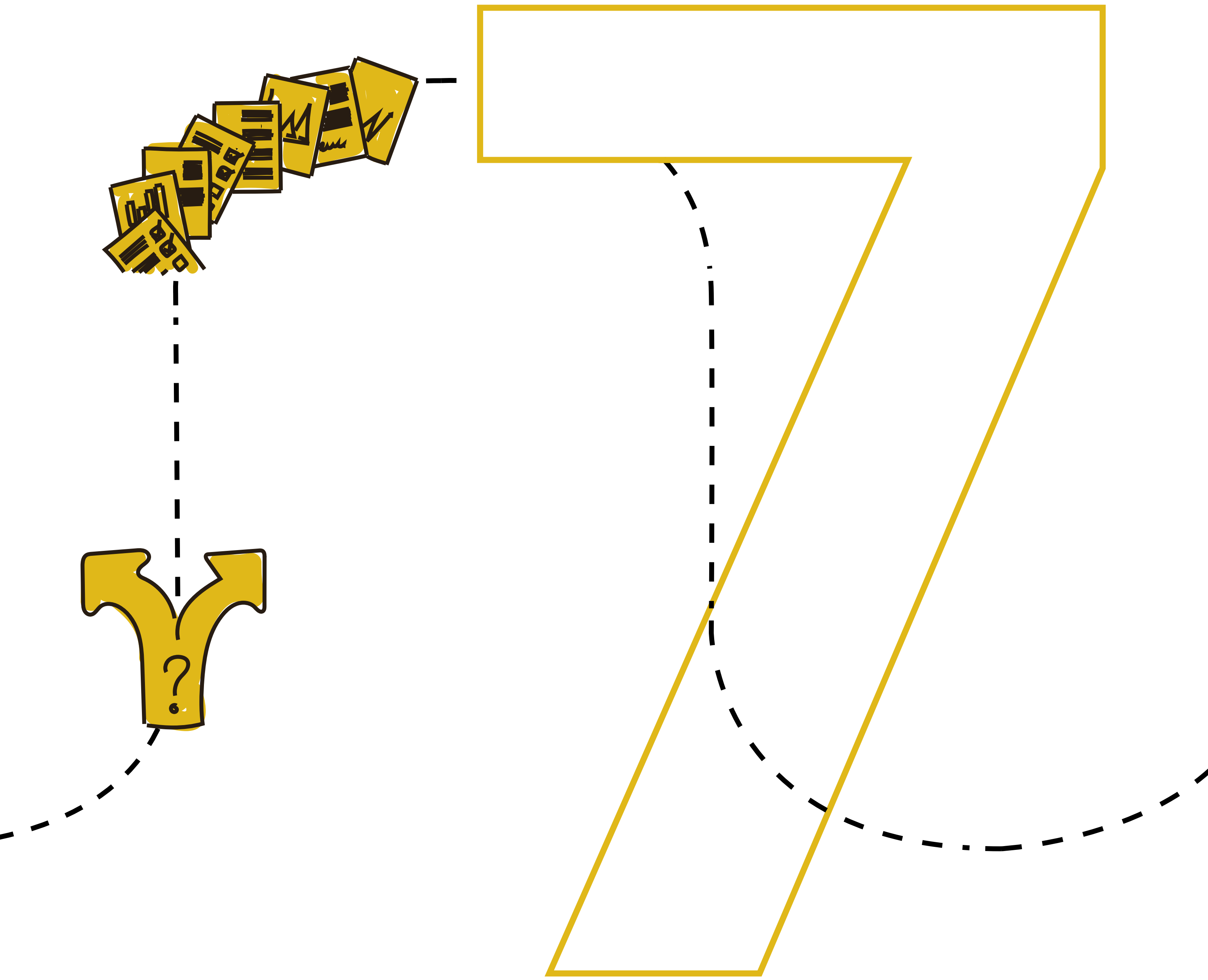
Financing Terms

Guide to using Term Sheets

Social Investment Toolkit | Module 7



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Content

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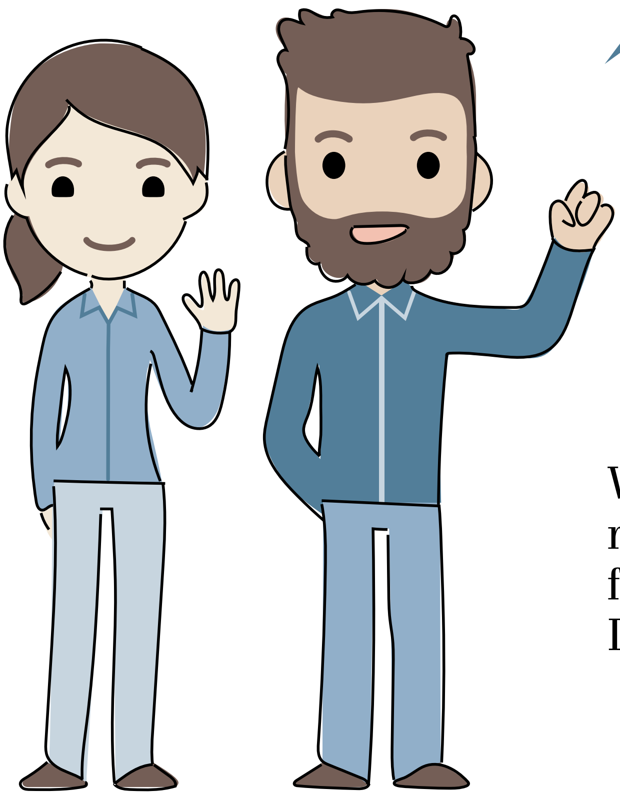
We are deeply grateful to international law firm Hogan Lovells, our Content Partner for this Module, for their input in helping us provide these Term Sheets and notes for your use.



We are keen to receive your feedback for the Social Investment Toolkit.

What is a Term Sheet?

This Module 7 of the Social Investment Toolkit is about helping you set out the terms of your Financing Offer to investors. Once you have decided which type of finance to raise (i.e. philanthropy, debt or equity) and how much, you are now ready to set out the terms on which you wish to raise finance. What kind of terms and conditions are you willing to accept? For example, if you are selling equity, what proportion of your company are you offering to sell? If you are raising a loan, what interest rate would you pay, and how long would you need the loan for?

It's important for you to decide these terms for yourself before you begin speaking to investors.

The tool to help you do this is the Term Sheet. A Term Sheet is a short summary setting out the key terms of your financing offer to investors. It is not a legally binding document. It is a way for you to have a discussion with investors on all of the key points for negotiation concisely. Once the Term Sheet has been finalised and agreed by all parties, it can then be provided to lawyers to be converted into formal legal agreements by your legal advisor.

It is advisable to work with Term Sheets rather than legal documents in your negotiations with investors. It is much faster and less cumbersome, and will save time and cost of repeated re-drafting.

There are several advantages of working with a Term Sheet. The first is that it captures in one place all of the key items under discussion. The term sheet can be continuously updated as parties add comments, but there should always be one version that is recognised as the 'latest version' that everyone is working with. This way both investors and your team can easily keep track of the current state of discussions, and see which points remain open.

Another advantage is that a Term Sheet makes it easier to manage negotiations with different investors at the same time. At the start of negotiations, you should present all investors with the same Term Sheet. Once comments and requests start to come in, you may find it helpful to use one Term Sheet to manage all comments. This way you end up negotiating a single set of terms with all investors, which you will need to do if you raise investment from more than one investor.

At the end of the day, you are going to sign a single Investment Agreement with multiple investors, and so you need a process where everyone gets on the same page. Having a single Term Sheet seen by all parties helps you achieve that.

We provide in this Module a Sample **Loan Term Sheet** as well as a Sample **Equity Term Sheet** that you can use as examples of Term Sheets.

How do you prepare a Term Sheet?

To prepare a term sheet, you should sit down with your finance team and go line-by-line through a standard term sheet template to set out the key terms on which you wish to raise finance. Your advisors may have their own standard term sheet formats, or you can see sample term sheets which we provide in this Module.

We recommend that your team prepare your own Term Sheet rather than relying on investors to create one for you (which many will happily do). By creating your own Term Sheet, you take control of the conversation and begin with the terms that are most favourable and acceptable to you. If an investor provides you with a term sheet, it will inevitably be loaded with terms in their favour from the start.

You should prepare a Term Sheet with your corporate finance advisor before approaching potential investors. A Term Sheet should be part of the Investor Materials that you prepare for investors when you are ready to seek investment (the other Investor Materials are the Business Plan, Financial Model, Pitch Deck and Due Diligence package – all of which we explain in Module 8).

A Term Sheet is normally sent to investors after you have made an introduction/pitch and they have expressed interest into entering into discussions around investment.

Once you start negotiations with investors, the discussions around financing terms are normally structured in two parts. The first phase – the 'Term Sheet Negotiation' phase – consists of your sending marked-up versions of the Term Sheet to each other and negotiating individual points until you agree on a final, settled version. This may take days or weeks depending on how far apart you are in your starting positions.

Once you start Term Sheet negotiations, you will need to bring in your legal and corporate finance advisors. Investors are also likely to bring in their own lawyers to advise them too. Negotiations will be a combination of legal advice as well as strategic or commercial decisions that only you can make (e.g. how much of the venture are you willing to sell?).

You should sit down with your advisors and work out for every item in the Term Sheet whether each item is a 'must-have', 'negotiable', or 'could be dropped if necessary'. For items that are 'negotiable', you should work out within what range you are willing to negotiate, and against what items you might be able to trade. For example, if you are raising a loan, what is the maximum level of interest rate that you would be willing to pay? Could you trade a higher interest rate in exchange for a longer period to repay? If raising equity, how much ownership are you willing to give up at this point in time?

In particular, be clear with yourself from the start which items are your 'non-negotiable' – points that you would be willing to walk away from an investment if you do not get. For some ventures, this might be a maximum level of ownership they are willing to give up, or the level of influence that investors will have over the governance of the venture (for example, through the number of board seats offered to investors, or special voting rights given to them). Unless you are desperate for cash and have no choice but to take investment on any terms available, you should always be willing to walk away from a potential investment if you cannot agree terms.

In our Sample term sheets, we provide some comments alongside each item to indicate some typical terms that we have seen in deals that we have worked on. However you should be aware that for social enterprise deals, there is no real 'market standard', and every deal will be negotiated on a bespoke basis. The items that you will see in our Sample Term Sheets are typical and indeed the bare minimum in their scope. Expect more items to be added depending on the precise nature of your venture and also investor requirements.

What is the format of a Term Sheet?

You can see the Sample Term Sheets that we have provided in this Module, which can be downloaded alongside this work-book. Term Sheets are normally split into two columns. The column on the left gives the main topic, and the column on the right specified in very concise bullet points the terms relating to that item. Items in [square brackets] are for you to fill in with the information that is appropriate for your financing offer.

For example, here are the first four items for the Loan term Sheet for our case study SolaRise:

Item	Terms
Borrower	SolaRise Ltd A Company incorporated in United Kingdom with company number 0221564 whose address is at [address of SolaRise]
Borrower Group	The SolaRise Borrower Group comprises SolaRise UK Ltd (parent company) SolaRise Tanzania and SolaRise India All members of the Borrower Group agree to guarantee the Borrower in respect of its performance and obligations under this Loan
Loan Amount	USD 850,000
Currency	The Loan, together with all fees and interest payments, shall be denominated in USD

You can see how in a few simple boxes we are able to set out that SolaRise will be borrowing USD 850,000 through a company called SolaRise Ltd, which is incorporated in the UK. SolaRise Ltd has two subsidiaries – SolaRise Tanzania and SolaRise India – and all companies are jointly responsible for repayment of the loan. These terms can now be easily seen by potential investors and easily negotiated, without having to wade through pages of legal documentation.

In our sample Term Sheets, we also provide a third column containing our Notes explaining each item. These are purely for your own benefit and this column can be deleted once you have finished filling out the Term Sheet.

We will now talk you through the main features to look out for in a Loan Term Sheet and an Equity Term Sheet. The detailed discussion of each item on the Term Sheet can be found in the Term Sheet itself, in the Notes on the third column.

Loan Term Sheets

The most likely form of debt that you would raise is a Loan. Loans differ from equity in that you are not selling ownership in your venture; rather you are borrowing money that will need to be repaid with interest by a certain date.

The key features that characterise a loan are:

1. **Commitment / Size of Loan:** i.e. the total amount of funds that Lenders 'commit' to you. This is referred to as a Commitment because you may not wish to draw down all of the funds in one go if your funding needs are spread out over more than a year. It may be more efficient to draw down funds over time to save on interest costs. If so, you would need the lender to 'commit' to providing you with funds in future. The time period in which lenders commit to keeping funds available for you is known as the 'Commitment' Period. However, if all of your capital needs occur in the next 18 months, we recommend that you draw down the loan in a single instalment. The amount of a Loan that you actually draw down is known as the 'Loan Balance' outstanding.

2. **Interest rate** on the Loan (expressed as an annual percentage rate on the loan balance outstanding). In a mature market such as the US, UK, Singapore or France, a social venture raising a loan with an interest rate of 0–5% would be considered 'below market rate', and 5–12% closer to 'commercial rate'. Above 12% would likely be considered high. In an emerging market, interest rates of 10–15% or even higher are common. 'Market rate' will vary widely depending on which market you are raising funds.

3. **Maturity:** this is how long before the loan must be repaid. The final day of the Loan is known as the Final Maturity Date. You will probably want to have as long a time to repay as possible. For a typical unsecured social investment loan 3–5 years is standard, 7 years would be good and 10 years would be exceptional. Longer than 10 years is rare unless you have a venture that has a very stable long term customer contract, or you are able to secure your loan against an asset such a building. Development banks such as the International Finance Corporation (IFC, part of the World Bank) can provide very long term financing (10 years+) but it is rare to see a commercial bank doing so.

4. **Repayment Profile:** this is the schedule of payments that you must make to repay the loan in instalments over the maturity of the loan. Repayment instalments can be monthly, quarterly, 6 monthly or annual. Ideally, repaying less frequently is more helpful for administration purposes. You will probably want your repayment schedule to be as 'back-ended' as possible. In other words, payments should be light in early months and increasing over time, to give you more time to grow cash flow. There may even be a period of time known as a 'grace period' when you don't have to repay the loan.

   On the other hand, investors will probably want to see repayment faster so that they can get their money back sooner. The loan repayment schedule is therefore a matter of negotiation. Sometimes you can trade a higher interest rate in exchange for a more lenient repayment profile. You can use your Financial Model to see the benefits of such a trade-off. Having longer to repay will result in lower monthly payments, so it may be preferable even with a higher interest rate.

   Some social ventures succeed in raising a 'flexible' repayment profile. A 'flexible' profile is one where repayments are only made if there are sufficient profits to repay; otherwise the loan instalment rolls over into the next repayment period (until the Final Maturity Date, whereupon all unpaid amounts must be paid). This reduces your risk of not being able to make a scheduled repayment, and therefore lowers your risk of bankruptcy.

5. **Fees** that must be paid upfront in order to arrange the loan (the 'Arrangement fee') – this can sometimes be waived for social investments. If your lender is offering you a Commitment Period (see above), they may also charge you a 'Commitment fee' which is similar to an interest rate on amounts that are committed but not yet drawn. The Commitment fee is always lower than the interest rate, so that it is always more efficient to draw down funds only when you need them.

6. **Covenants:** Covenants are the conditions and requirements that come with a loan. They are the main means by which Lenders protect themselves and achieve some degree of 'control' over Management. In our Sample Term Sheet you will see standard covenants such as the requirement to provide Lenders with your audited accounts on a timely basis. Failure to honour a covenant results in an Event of Default. If you default on the loan, the Lenders will have the right to 'accelerate' the Loan, which means that it must be repaid immediately. Failure to repay the Loan will result in the lenders being able to call the venture into liquidation and sold in order to raise cash to repay the loan (to the extent possible).

7. **Security:** this comprises any assets that you are able to offer such as buildings or equipment that can be offered as 'security' or 'collateral' to a lender. If you default on the loan, the Lender will have the right to seize the asset and sell it, to recover some of the loan. Offering security should result in you obtaining better loan terms (e.g. lower interest rate, longer repayment profile, larger amount of funds) than you would otherwise be able to. Sometimes cash flow from customer contracts can also be used as security. If you have a sizeable customer contract, for example, you may be able to offer this as security in order to be able to obtain a loan. Most social ventures do not have many suitable assets and therefore most social venture loans are unsecured.

8. **Conversion:** Some start-up loans have a feature called 'Convertibility' in which they can convert into equity under certain conditions. These are normally either on the occurrence of certain 'Conversion Events' (normally the issuance of new shares, or when the company is bought out or listed on a stock exchange) or at the option of the Lender. Convertible loans are often used when a venture is very early stage (at the 'seed round' of investment or earlier) and neither Management nor Lenders wish to set a valuation of the company before a genuine track record has been established. The Convertibility option enables Lenders to take shares in the company at a later stage when it is more established (and usually at a discount to any new shareholders), but if the company fails to grow or to raise new shares in future, they can be paid out as a normal loan.

In this Module, we provide you with a **Sample Loan Term** Sheet which contains a Conversion feature.

Equity Term Sheets

An equity term sheet set out the terms on which you are willing to sell a proportion of the ownership of your business. This is done through the selling of shares in a for-profit legal entity (since only for-profit entities can issue shares).

As mentioned earlier, there are two main kinds of shares: Ordinary Shares and Preferred Shares. Ordinary Shares are the normal shares held by the founders and early investors. Preferred Shares are the most common way in which new investors put their funds into the Venture.

Preferred Shares rank ahead of Ordinary Shares in any payout, including any distribution of profits. Preferred Shares hold voting rights similar to Ordinary Shares, and in some cases may have special voting rights where only the holders of the Preferred Shares are allowed to vote. Preferred Shares convert into Ordinary Shares under certain conditions, such as if the company were to be listed on a stock exchange.

You may also sometimes hear about 'Golden Shares'. A golden share is not a third type of share, but rather a class of Ordinary or Preferred Shares which is designated with special voting rights beyond the normal rights associated with its shareholding. Golden Shares are often used by social ventures as a means to protect the social mission of the venture, by allowing a special investor (such as the founder or a foundation set up to preserve the social mission of the venture) special controls over key aspects of the business, such as the ability to veto any changes to the Venture's stated social mission.

We provide a sample **Equity Term Sheet** which can be used as the basis for a Preferred Share or an Ordinary Share investment.

Here are some of the key items to be aware of when negotiating an Equity investment:

- **Share Price and Valuation:** One of the central topics will be the share price which the shareholder must pay to buy the shares. The share price multiplied by the total number of shares issued gives the 'valuation' of the Company. We discuss valuation in Module 5 ('Financial Model') as well as elsewhere in Module 7 ('Financing Terms: Choosing a Financing Option').

- **Shareholder Voting rights:** The Equity Term Sheet should set out under what kinds of decisions shareholders will get a vote on. Certain shareholder decisions may require a 'super majority' of the shareholders to agree to (super-majority is often set at 75% of all shareholder votes, although this threshold may be set higher or lower). These decisions are normally highly significant ones for the company, such as whether to buy or merge with another company, or to cease trading, change the business etc. Anything which directly affects shareholders, such as issuing more shares, is likely to be subject to a shareholder vote. Preferred Shareholders may also want some votes to be made solely by themselves, not Ordinary Shares. This will be subject to negotiation.

- **Leaver Provisions:** the Term Sheet will typically specify what happens to a Founder's shares if a Founder leaves the company. There are two standard types of departure: 'Good Leaver' and 'Bad Leaver'. A Good Leaver represents the situation where a founder leaves on terms acceptable to the board. A Bad Leaver represents every other situation, which is the majority of cases. In whichever situation, the Company normally has the right to buy back the departing founder's shares, so as to avoid a situation where a founder is no longer actively engaged with the company but still continues to wield a strong shareholder vote. The price paid for the departing founder's shares is usually the lower of the share price paid in the last round of investment, or Fair Market Value (i.e. some determination would be need to be made of what a fair value of those shares might be). In some cases, the buy back right may be exercised at a nominal rate, or a very low rate, especially if the founder left for reasons such as gross misconduct or breach of contract. Our Sample Term Sheet contains fairly standard provisions in this regard, but you may get some investors who wish to negotiate this point more harshly (i.e. seek a lower share price buy back in the event of a founder departing).

- **Liquidation Preference:** when the company is sold, any cash received is first paid to the Preferred Shareholders, with any remainder (if any) available for Ordinary Shares. Sometimes Preferred Shareholders require a greater pay-out than simply their original invested amount. The 'Liquidation Preference' represents the multiple of the original investment that the Preferred Shareholder will receive in a pay out scenario. For example, a liquidation preference of 2x means that the Preferred Shareholder will receive up to twice their original investment if the company is sold. Some investors may seek a Liquidation Preference of greater than 1x as a means to give themselves some financial return even if the company does not perform well, or if they have particular leverage to extract better terms from you. In normal market conditions, a Liquidation Preference of 1x has become standard for many deals. Note – our standard Term Sheet does not include this provision (which effectively means the Liquidation Preference is set at 1x). However if requested, you should be aware of how this term works.

- **Tag Along** – the Tag Along right gives shareholders the right to sell their shares to any future buyer who purchases shares such that they become a controlling shareholder (i.e. take more than 50% of the shares). The tag along threshold may sometimes be higher than 50%. This is a means to ensure that anyone who buys a company can be forced to buy out all minority shareholders as well, so that some shareholders are not left in a company whose control has changed.

- **Drag Along** – the Drag Along clause is the opposite of the Tag Along. The Drag Along gives a purchaser of shares who becomes a controlling shareholder (i.e. acquires more than 50% of the shares outstanding) to buy out all remaining shareholders on the same terms and price. This gives the purchaser the right to become the sole shareholder if they wish, rather than being left with a significant number of minority shareholders still in the deal after they have bought the company.

- **Anti-Dilution** – when a company issues new shares, all of the existing shareholders suffer a proportionate reduction in their ownership of the company, and potentially therefore a loss of value since their ownership stake has been reduced. An anti-dilution clause protects shareholders against this by issuing further shareholders to the existing shareholders so that their proportionate ownership stays the same. Giving anti-dilution clauses to Preferred Shareholders can be problematic because it makes it harder to raise new capital (since many more shares will be issued and new investors may not get the ownership stake that they wanted). Ordinary shareholders will be the ones most negatively affected since Ordinary Shares rarely get the benefits of an anti-dilution clause. We mention this here because anti-dilution is a frequent request from shareholders, but is rarely a feature that should be offered with getting some significant benefit in return. (Note – our sample term sheet does not include this provision).

Using our Sample Term Sheets

In this Module, we have provided some sample term sheets that you can download and review for either debt (Loan) or equity (Ordinary or Preferred Shares).

We provide comments in the right-hand column to explain more about each term sheet item. If you wish to adapt these term sheets for your own use, please feel free to delete the right hand column and fill in the items in square brackets in the central column.

Creating the terms of a financial investment is complicated, so we strongly recommend that you do this exercise under the guidance of a finance professional as well as with your legal advisor's input.

We provide below some additional guidance that you may find helpful when you are working either with a debt Term Sheet or an equity Term Sheet.

Work with your financial advisor, select the appropriate sample term sheet (Preferred Share or Convertible Loan) and go through it item-by-item, filling in indicative terms in the square brackets where indicated. In the notes in the column on the right hand side, we provide suggested guidance on how these terms might be filled in, and some common market terms. Note however that there is no market standard, and whatever terms you are able to offer/achieve will be subject to the specifics of your situation, as well as your ability to negotiate with investors. Please feel free to delete items that are not applicable, or that you don't wish to offer.

The Convertible Loan Term Sheet can be easily adapted into any other form of loan simply be amending the terms accordingly (for example, if you wish to have a conventional loan, simply remove the sections describing the conversion option).

Please see also the Sample Loan Term Sheet and the Sample Equity Term Sheet.

Investor Recap

- Term Sheets are an invaluable way to negotiate with investors on your financing terms.
- When preparing to approach investors, you should make sure that you compile your own Term Sheet as a starting point. This enables you to start with the terms with which you are most comfortable, and set at the parameters that you are willing to raise investment.
- You should work with experienced finance professionals in developing a Term Sheet.
- You should have a sense of what are your 'must-haves', 'can be negotiated' and 'not important' items on your Term Sheet. You should also have a sense of which items you would be willing to trade against other items in order to secure your aims.
- During a negotiation, it is quite common for a Term Sheet to go through multiple rounds of mark-up, so you need to keep track of the latest version of the Term Sheet carefully.
- Use track changes on the document, so that all parties can see what has changed since the last version of the Term Sheet.
- Only move onto legal documentation once the Term Sheet has been agreed and signed by all parties. This will not only save time and lawyers' fees, but the act of bringing the Term Sheet to signing is a way to signal closure on negotiations, and have a definitive cut off point beyond which further revisions need not be accepted.
- Once all parties have signed the Term Sheet, the documentation phase should move much quicker and hopefully smoothly. Discussions at that stage will be around drafting, and hopefully not on re-opening commercial points of negotiation.
- The Term Sheet marks an advanced stage in the capital raising process. In the final Module of this Social Investment Toolkit, Module 8 ('Approaching Investors') we explain the process of approaching investors once you have prepared your Term Sheet, as well as which other information items you will need to prepare for investors.

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