Valuations and Term Sheets

June 2024

Valuation

Summary

What are we learning about today?

- Establishing backdrop on valuation considerations for defense startups
- Building common language on valuations and items in term sheets
- Considerations when establishing a valuation
- Lead investor rights vs other investors
- Benefits and pitfalls when reviewing term sheets

Before 2022

Capital-rich macro environment - “seller’s market”

- Capital was easy to raise, even for capital-intensive businesses
- Large LPs received big VC returns in 2019-2020 and reinvested those funds into venture, fueling growth capital valuations
- New entrants like large cap hedge funds (Tiger, Coatue, Softbank, Point72) were pushing the market up with no sensitivity to company valuations
- IPO market was strong and provided exit opportunities for VCs
- Companies could command great terms from their investors and were encouraged to push for more capital injection at high valuations

Starting in 2022

Interest rates high and no IPOs - “Buyer’s market”

- Large amounts of Dry Powder (undeployed but committed funds at a venture firm)
- Flat investment valuations or down rounds (drops in valuations) are common
- Venture firms are emphasizing “structure” in deals (more on that later)
- There are much fewer funds looking to allocate to growth companies or companies requiring large amounts of capital
- Emphasis is now on raising enough capital to hit milestone objectives, and make sure the company’s runway is ~24 months, and don’t raise more than you need (to avoid dilution)

Setting Valuations

Setting a price for your equity is art, not science… and it is quite dependent on who is buying.

Valuation too low?

- You can't raise the amount of capital your business needs without being over-diluted. You aren't saving enough equity for employees or future rounds.

Valuation too high?

- You will have difficulty next fundraise - you didn't justify the price early investors paid. Might need to be creative to get additional capital.

Setting Valuations - Rules of Thumb

Simple math can yield some fairly specific results.

Top Down Approach

What is the total amount of dilution I'd like to take to ensure I have stock left to issue in future rounds? **20% is a good target.**

What is the total amount of capital I need over the next 24 months to complete the milestones I've specified? **$Xmm.**

$X / 20% = **$Ymm valuation**

Bottom Up Approach

What is the total amount of capital I need over the next 24 months to complete the milestones I've specified? **$Xmm.**

What is the valuation of my company based on what I've accomplished to-date and the willingness of an investor to believe my future aspirations for the business? How much of the company will they need to fit their model? How much do I want to sell at that value? **$Ymm valuation.**

Term Sheets

Term Sheets

Why do these exist?

They serve as a guide for negotiating business items of the transaction.

Term sheets are not legally binding.

While rare, both sides can technically rescind a term sheet, even if it's "signed."

After a term sheet is agreed-upon, your counsel or their counsel will draft legal documents based on those terms. Those drafted legal documents are legally binding (typically an amended articles of incorporation or an amended LLC operating agreement).

Structure! Who can ask for it?

Not every investor will have the same rights! As a founder, you have to manage expectations.

Terms a Lead Investor can possibly ask for (generally):

- Board Seats
- Liquidation preference (incl. 1x+, participating)
- Information rights
- Tranched investments through milestones
- Anti-dilution privileges
- Most Favored Nation clause
- Additional warrants / stock options

Terms a non-lead investor can possibly ask for (generally) but you might not give:

- Same terms as the lead investor (they can ask)
- Information rights
- Board observer seats

We will discuss each of these above items in the following slides.

Term Sheet terms - negotiable items

Item	What does this mean for me?	Common, and Negotiable?
Board Seats	You can expect to grant board seats in an *equity* fundraise.	Common, **negotiable**
Preferred shares	When raising equity, you can expect to grant preferred shares, which defines their right to these other terms.	Common, non negotiable
Liquidation Preference	IF your company has an exit, shares with liquidation preference get paid out first. Watch for how these stack.	Common, **negotiable**
Covenants (performance metrics, milestones)	Investors may ask for investments, typically debt, to have milestone expectations (sales, grants raised). Could trigger other terms like tranching, splitting the investment.	Somewhat common, and **negotiable**
Debt - interest rates, variable interest	Most debt (except SAFEs) comes with a defined interest rate On that capital, which will add to the amount of shares in which the notes convert. Sometimes the interest rate ratchets over time.	Common for convertible notes and standard debt, **negotiable** (within reason, not less than ~5%)
Key Person clauses	An investor may ask to "protect their investment" by allowing them to get capital out if the founder is incapacitated.	Not too common, and not negotiable if asked

Term Sheet terms - negotiable items (continued)

Item	What does this mean for me?	Common, and Negotiable?
Most Favored Nation terms	The investor who receives these rights has the right to match any terms you've offered another investor which they feel are better terms. If you are trying to attract capital through favorable terms, keep these clauses in mind.	Somewhat common, and somewhat negotiable
Anti-dilution	Investors generally want to maintain the right to add additional capital in the future to preserve their percentage of the company. Important to keep this in mind (can't get that investor's % of the company back over time)	Somewhat common, and somewhat negotiable
Information rights	Investors will ask for the right to financial and operational details.	Quite common, and usually not negotiable
Warrants or stock options including advisory shares	In addition to equity, some investors may request advisory shares. Keep in mind as these come out of common stock pool.	Not common, **fairly negotiable**
Board observer rights	Board observers don't vote but they do sit in on meetings.	Quite common, and **fairly negotiable**

Important considerations

1. **Lead investors will negotiate the term sheet with you, and other investors will often follow on the same term sheet.** Rights that you surrender as a company in a term sheet are sometimes items that are then offered to all investors.
2. **Board composition is important to get right.** Board seats are a “big deal” and you should treat giving them with care, as you decrease your own rights as a board member by issuing additional seats.
3. **Dilution is one of the most critical items to manage.** Every new equity investment will add dilution, but term sheets contain other hidden dilutive events (ratcheting interest, anti-dilution privileges) that should be considered When you calculate your ”fully diluted” cap table.

Demonstrating traction to a VC in defense markets

Grant Programs

The DOD is consistently looking for new ways to demonstrate intent and to find new technology companies. They do this often through grant programs (i.e. SBIR/STTR). VCs will use them as both customer (DOD) signal and signal for a possible investment.

Structuring Milestones

Breaking product development up into piecemeal milestones helps signal realistic expectations to VCs who want to see approachable goals and your progress towards them.

Milestone 1 & 2, done by..

Series Seed
$Xmm raise
15-20% dilution

18-24mo →

Milestone 3 & 4, for Customer X, done by..

Series A
$Xmm raise
15-20% dilution

18-24mo →

Milestone 5 & 6, for Customer X, Y, Z, done by..

Series B
$Xmm raise
15-20% dilution

18-24mo → …

Defense focused VCs are extremely patient - if they are investing in companies doing work with the US government, they have already signed up to work with companies with long sales cycles.

Questions?