South Africa Term Sheet Guidance Note Commentary

Developed by Endeavor South Africa

In Partnership with Digital Africa Collective

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Please send all edits / comments to info@endeavor.co.za

Objective

The objective of this project led by Endeavor South Africa (Endeavor), in partnership with Digital Africa Collective is to provide guidance to African (Sub-Saharan) entrepreneurs and investors involved in raising Seed or Series A capital with a working template that can be customized to specific funding circumstances. *Note: We started with Southern Africa and plan to extend this to East and West Africa by end 2020.* The term sheet that follows includes standard terms as well as some non-standard clauses as arise in our discussions with growth-stage companies. It is by no means exhaustive, and various terms may indeed not be included in a term sheet and/or may be mutually exclusive.

The working term sheet with appendix and glossary of terms are included in the term sheet guidance note and have been reviewed by SAVCA and a selection of local funders. This separate document contains founder-friendly advice and commentary compiled by Endeavor (through its local & global network of high-impact entrepreneurs) for founders raising capital. This document should be viewed with the term sheet guidance note in section 1 and 2.

The intention is that this will remain a working document and is updated on a regular basis. At the date of publishing the document relates only to Seed / Series A raises in South Africa.

Introduction

Typically the purpose of a term sheet is to be a non-binding summary of terms between an investor and company that lays out the proposed commercial arrangement of a future investment. Some term sheets may state that all terms are binding, or some terms (confidentiality, no shop, etc) will hold despite the outcome of the transaction.

Once finalised, the term sheet is converted into long-form legal agreements. Negotiating and finalizing clear term sheets in advance is critical to save you time and resources in the legal process.

If you are raising capital outside of South Africa, we recommend using templates from NVCA for US raises and The Galion Project for European raises. Term sheets for equity investments are different from SAFE notes and debt investment rounds. For SAFE rounds please refer to Y Combinator's template.

Disclaimer

This indicative term sheet document, its commentary and annexures are intended to serve as a starting point only and should be tailored to meet your specific capital raising requirements. This document should not be construed as legal advice for any particular facts or circumstances. Note that this sample document may present a range of (often mutually exclusive) options with respect to particular deal provisions.

None of the opinions stated in this document are necessarily any of the individual views of the contributing parties. Always check the terms in your agreements with a legal expert, despite the non-binding nature of a term sheet. Neither Endeavor nor the contributing parties may be held liable for losses incurred by the use of any part of this document.

SECTION 3: Pitfalls and Terms to Watch Out for

Participating Preferred and Non-standard Liquidation Preferences	Note that liquidation preferences may not appear in early stage term sheets, as they can put off future funders in later stage rounds. A participating preferred right gives investors the right to claim a multiple of their initial investment in the event of liquidation. Where present, a 1x standard, non-participating liquidation preference with/without declared but unpaid dividends is market-related. We recommend that founders assess the consequences of future funders requiring their own layers of liquidation preferences at a later date, and that founders limit the multiple on cash available on the occurrence of a liquidation event to no more than 1x.
Protective Provisions	Protective provisions are designed to give investors a say in the major strategic and operating decisions of the business. This clause is incredibly important, as some investors would prefer to have as much control as possible but may leave you hamstrung in running your business. This can also be problematic where a business has many small minority shareholders who all want a say in how you make decisions as a management team. We recommend that shareholders with a minimum equity ownership (e.g. 10%) are offered protective provisions exclusively. We also recommend splitting protective provisions into those that materially affect the company's valuation and strategic direction (requiring 50% - 75% shareholder approval) and operational decisions that should be shared as a courtesy on an information-only basis.
Legal Fees	Legal fees (whether the deal goes ahead or not) are usually for the company's account. We encourage investors to pay their own legal fees and leave the company to invest cash into the business. At the very least, aim to place a cap on legal fees incurred on the term sheet.
Term sheet expiration	Term sheets can include an expiration, which places founders under immense pressure. It is critical that you find the right investor and that the fit and chemistry is right for the business. Take your time and in some circumstances go as far as requesting that expirations are removed.
Option Pool	Term sheets may create a requirement to establish a share option pool for senior hires and incentives. Who pays for this pool is critical. If the term sheet states that the pre-money valuation must include a fully diluted post money option pool, it means that the founders and existing shareholders essentially pay for the full option pool. This means that future hires who may be offered shares as part of the ESOP or internal option pool dilute the founders' equity, but not the new investors' equity. This part of the negotiation essentially comes down to a valuation or pricing discussion as carving the ESOP out of the pre-money valuation serves to reduce the price per share for incoming investors. Our view is that new hires benefit all shareholders and all should dilute when new senior team members are hired.

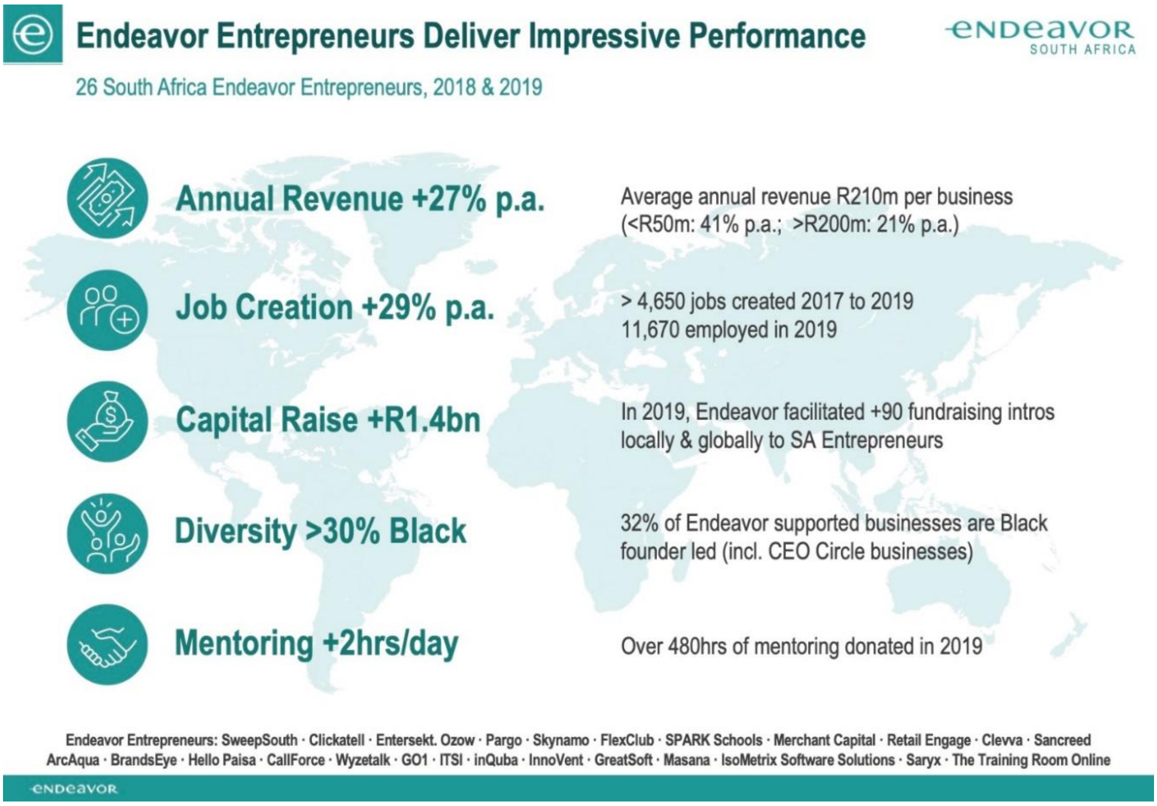
	The recommended alternative is to estimate the pool you will need to attract and retain top talent (5-15% of ordinary shares) and to add at least a portion of this to the post-money valuation. The investor gets the option pool and the founder gets a better price.
Over-complex deal structures	These can result in unintended consequences, including over-dilution for founders down the line. Try to keep the structuring as simple as possible. Remember that future rounds will use earlier rounds as precedent, so include the terms you want early on and be wary of tying the company into structures that could affect later rounds.
Imbalances in the stakeholder group and cap table	The key to achieving balanced governance is to diversify your stakeholder groups and cap tables. Ensure that you have a proper Board structure, even as an early stage company. Advisory Boards can play a very important role in supporting the team with expertise as the company grows. Establish key voting thresholds for corporate events to include a blend of founders and investors. Research shows that founders who dilute below 50% of the ordinary shares in the company tend to look to investors for strategic direction. When diluted below 10% founders see themselves as employees or the business as a side hustle. The recommendation is to aim to sell no more than 30% -40% of the company in a combination of Seed and Series A rounds. Later stage investors will look for balanced cap tables to ensure that founders have enough equity to incentivize them to continue to build the business.
Leading investors on	Investors truly dislike taking immense amounts of time and resources to progress toward a transaction, only to be excluded at the last minute. While this must be a 2-way street, bear in mind that there is an etiquette to courting investors and getting it wrong could be reputationally and commercially fatal.[1]
Legal detail trumps personal relationships	The legal terms required by investors are important to establish the ground rules for a sustainable, productive relationship. Bear in mind that it is unfavourable for all parties to ever follow a legal course of action. The quality of the relationship between the founders and investors is the key to success for the business. Be rigorous about the legal detail, plan for future funding rounds and be deliberate and intentional in working on your relationships with your investors.
Not appointing an advisor	Founders are experts in their fields and laser focused on running their businesses. Funders are experts in capital raising, legal agreements and structuring. Where you are raising a large international Series A or B round we strongly encourage bringing an experienced advisor into your negotiation with track record of raising capital in the appropriate region. The right advisor will cost 3-5% in capital raising fees but may save you far more down the line if they can assist with avoiding problematic terms. Note though that appointing an advisor does not recuse the founders from knowing the business and commercial metrics in detail!

[1] See the legal case between Havaic and Custos.

Raising too much / too little capital	Capital raising takes a long time and requires 10-20% of the founders' time. The management team distraction is hard to quantify, but it can cost the business in money and lack of focus. At the same time, raising too much capital too soon results in over-dilution in the early stages of capital raising. On average, Endeavor Global sees capital raises across the world take around 8 months. In Southern African environments it can take far longer from initial discussions to closing a round. Add margin on to your capital raise amount to aim to raise capital every 18-24 months. Maintain relationships with investors long before you need to approach them for capital.
Complex Vesting Schedules	Founder vesting does not always exist in term sheets, and in a South African context, can be replaced by other protections like founder lock-ups. Vesting is complex and tends to create a conflict between the founders and investors. Typically founders' shares vest over time provided that they don't leave the company on a "bad leaver" basis. The definition of "good leaver", "gray leaver" and "bad leaver" is critical here, as it may create an opportunity to dismiss founders for the "wrong fit" or "poor performance". Definitions around vesting should be clearly set out in the term sheet. A few things to note: • Founder vesting should not be linked to ESOP vesting (this typically has far stricter terms as is in return for future work, not having been earned already). • Structure vesting of founder shares to be more lenient as new funding rounds are raised (i.e. 25% of founder shares excluded at a seed stage and more thereafter). • Vesting should accelerate so that majority of the vesting schedule has taken place by the time of the next raise. Be aware that vesting can be "reset" at your next round of funding, meaning that vested shares may not be vested forever. The reason for this is that should a founder leave, their replacement will also require equity, which could in turn dilute shareholders. Negotiate "accelerated" vesting on the next round of financing or on a good-leaver or gray-leaver basis where a portion of unvested shares vest on termination without cause. Note – the definition of "cause" becomes critically important here.
Future Dilution for SAFEs and Convertibles	SAFEs can be problematic for founders if the fully diluted cap table is not well understood before raising a convertible round. Valuation caps and discounts can create far more equity dilution for founders than anticipated and can cause tensions when raising capital from equity investors.

	Other pitfalls include assuming that the valuation cap on a SAFE is the floor to your next priced equity round. In addition, any discounts applied in a SAFE will not necessarily translate into a minimum premium on a future raise. Understand the impact of convertible notes on your cap table and avoid layering SAFE notes prior to raising a fully priced round. Bear in mind too, that VCs may require a minimum equity holding, which may not be possible if there are too many convertible notes outstanding.

Endeavor is a global organization present in 35+ countries that works to catalyze long-term economic growth by selecting, mentoring, and accelerating the best high-impact entrepreneurs worldwide. Endeavor South Africa currently has 26 Scale Ups in its program, 50+ in its pipeline and receive pro-bono support from 125 mentors. These 26 Scale Ups have average annual revenue of R210m per business and over the past 2 years have achieved 29% annual growth in headcount and 27% growth in annual revenue - collectively creating additional 4567 jobs and generating incremental revenue of R1.7bn. At end of 2019 these 26 Entrepreneurs jointly employed a total 11758 people and generated R4.7bn total revenue. The Endeavor South Africa board is chaired by Herman Bosman and the team is led by Alison Collier.



Linda's Rottenberg, Endeavor's co-founder and CEO, has some core insights about Entrepreneurship apt for our current situation: "turbulence is the official climate of entrepreneurship. Stability is the friend of the status quo. Chaos is the friend of the entrepreneur. Entrepreneurs' competitive advantage is being nimble and adaptable."