CROSSBOUNDARY ADVISORY

AGRF

Agribusiness Deal Room at the AGRF 2021

Overview of term sheets and key clauses

November 2021

AGRF PARTNERS

Agenda

1. **The Agribusiness Dealroom**
2. **Introduction to term sheets**
   i. Characteristics of term sheets
   ii. Common term sheet clauses
3. **Structuring equity term sheets**
   i. Terms impacting investment economics
   ii. Control rights and downside protection terms
4. **Structuring mezzanine term sheets**
   i. Types of mezzanine instruments
   ii. Common mezzanine terms
5. **Misconceptions around term sheet clauses**

Upskilling webinars are instrumental in helping enterprises prepare for investor conversations and support their growth ambitions

The team is conducting up to three webinars to upskill enterprises focusing on the following topics:

1. Understanding financial statements, forecasting, and building valuation models
2. Overview of equity and mezzanine term sheets and key clauses
3. Investment readiness including coverage of key documents such as pitch deck and investment memorandum

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1 The Agribusiness Dealroom

2 **Introduction to term sheets**

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ii. Common term sheet clauses

3 Structuring equity term sheets

i. Terms impacting investment economics

ii. Control rights and downside protection terms

4 Structuring mezzanine term sheets

i. Types of mezzanine instruments

ii. Common mezzanine terms

5 Misconceptions around term sheet clauses

Term sheets are non-binding legal documents containing the material terms and conditions of a potential deal, exchanged pre-due diligence

What is a term sheet?

- A term sheet is a non-binding legal document that parties exchange outlining the **material terms and conditions** of a potential business agreement, establishing the basis for future negotiations between the parties
- The document summarizes the main points of the deal agreements and addresses the differences. Term sheets are typically shared **before starting extensive due diligence** and/or **executing the legal agreements**
- A term sheet is **non-binding** and reflects only the key and broad points under which the investment will be made
- It also acts as a template for in-house or external legal teams to draft definitive agreements
- The contents and clauses of a term sheet **vary from transaction to transaction**

Deal process and key documents*

Deal sourcing	Preliminary due diligence & negotiation	Formal due diligence	Final negotiation	Closing
• Nondisclosure agreement • Preliminary letter of interest	• Term sheet	• First drafts of agreements	• Sale and purchase agreements • Other related agreements	• Final documentation • Corporate articles amendments

Some of the documents indicated primarily relate to equity transactions

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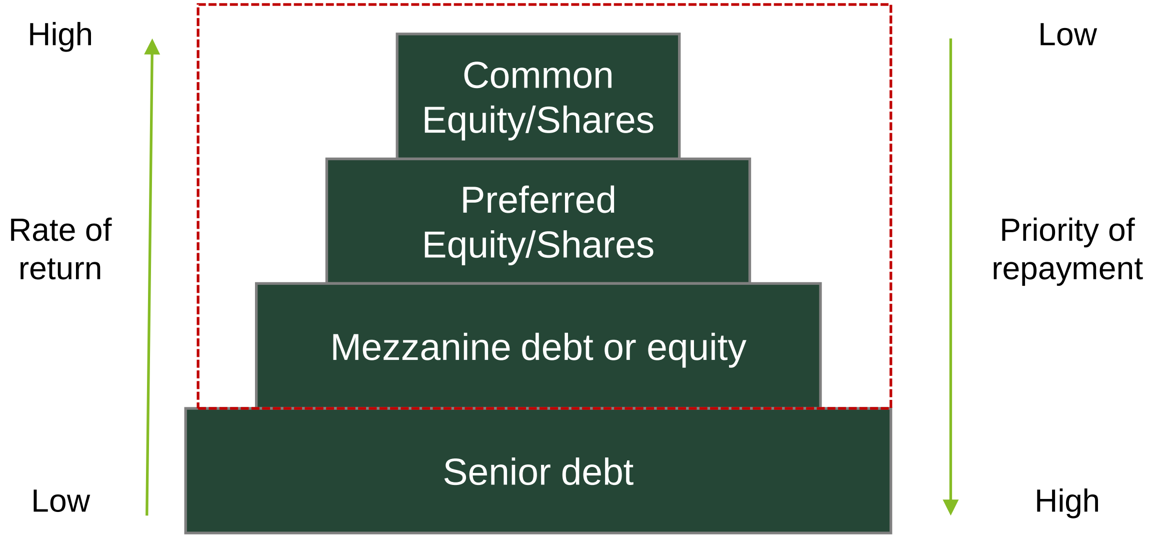
There are various types of financing instruments that an enterprise can use to raise capital



- **Common equity** is a security that represents ownership in a corporation. Holders of common stock elect the board of directors and vote on corporate policies. This form of equity ownership typically **yields higher rates of return** as common equity holders are **paid back last** after creditors, bondholders, and preferred shareholders in case of default
- **Preferred shares** are shares of a company's stock with dividends that are paid out to shareholders before common stock dividends are issued. If the company enters bankruptcy, preferred stockholders are entitled to be **paid from company assets before common stockholders**
- **Mezzanine financing** is a hybrid of debt and equity financing that gives the lender the right to convert to an equity interest in the company in case of default, generally, **after other senior lenders are paid**
- **Senior debts** are loans secured by collateral (assets) that must be paid off **before any other debts** when a company goes into default. The lender in this case is paid out of the sale of the company's assets in priority sequence. This makes senior debts **less risky** for lenders. As a result, the **interest rates and repayment terms for senior debt tend to be more favorable**

Term sheets vary from transaction to transaction, but most have the following components (1/2)

	Security	Key considerations
Terms that impact investment economics	Equity	**Type of security:** Rights, preferences, restriction levels, conversion rights (preferred equity)
		Valuation: pre-money valuation, post-investment capitalization structure, valuation adjustments
		Dividend policy: dividend payout formula, cumulative/non-cumulative (preferred equity)
		Liquidity preference: participating/non-participating (preferred equity)
		Redemption or repurchase rights: optional/mandatory redemption, redemption trigger, pricing, consequences from the failure to redeem
	Mezzanine	**Type of security:** subordination level, securitization
		Security structure: issue price, cash interest, payment in kind (PIK) interest, warrants
		Repayment: optional/mandatory repayment schedule, prepayment penalty

Term sheets vary from transaction to transaction, but most have the following components (2/2)

	Security	Key considerations
Terms that provide control rights and downside protection	Equity	**Terms that impact control terms –** voting rights, board representation, reserved matters
		Protection mechanisms – anti-dilution covenants, pre-emptive rights, drag along rights, tag along rights, rights of first refusal, transfer restrictions
	Mezzanine	**Credit pledges –** pledges of the shares, corporate/personal guarantees, lien on fixed assets
		Negative covenants – restrictions on financial indebtedness, related party transactions, dividend restrictions, sale of assets
		Affirmative covenants - Compliance with laws, Approvals and registrations, Selection of auditor
Standard Terms	All	Information rights, closing conditions, confidentiality clause, company representations/warranties, undertakings, no commitment, no shop clause, break up fee, costs and expenses

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The principal documents that govern an equity investment are a term sheet, subscription agreement, and shareholder agreement

AGRA Growing Africa's Agriculture

1 Term Sheet

- Outlines the key financial and other terms of a proposed investment
- Outlines certain conditions which need to be met before the investment
- With the exception of certain clauses (commonly those dealing with confidentiality, exclusivity and sometimes costs and break fees) provisions of a term sheet are not usually intended to be legally binding

2 Subscription Agreement

- Contains details of the investment round, including the number and class of securities subscribed for, payment terms and representations and warranties about the condition of the company and its key assets
- The subscription agreement is usually very similar to the term sheet and contains only a few new terms

3 Shareholders Agreement

- Legally binding agreement governing relations between existing shareholders and new investors
- Contains investor protections, including consent rights, rights to board representation, noncompete restrictions, rights attached to various security classes, procedures for issue and transfer of shares, and the holding of shareholder and board meetings

Once agreed by all parties, lawyers use the term sheet as a basis for drafting the subscription agreement and shareholders agreement. The more detailed the term sheet, the fewer the commercial issues that will need to be agreed upon during the drafting process

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Equity term sheets typically include provisions that impact investment economics (1/2)

Term	Usage	Description
Valuation	●	• This term sheet clause provides the information on pre-money & post-money valuations of the company • It specifies the percentage of the company that the investors will own, on a post-closing, fully-diluted basis • Valuation can be tied to a performance metric, e.g., Revenue or EBITDA
Dividend Policy	●	• Dividend policy determines what percentage of net profit/cash flow should be paid out as dividends • Preference shares are shares which are preferred over common shares in payment of dividends. Preferred dividends are paid either on a cumulative basis or noncumulative basis • Non-cumulative dividends are paid on the preferred stock only if the Board of Directors declares them; if they are not paid, they do not accrue and do not result in a future obligation to the preferred stockholders • The term “cumulative” refers to the fact that dividends accrue over the years and will be paid upon a liquidity event. Investors sometimes advocate for some form of cumulative dividend as a protective measure to provide a minimum annual rate of return on their investment and it is thus tied-into the liquidation preference. Preferred shareholders with a cumulative dividend feature must be paid first before dividends can be paid to non-cumulative preferred shareholders and common shareholders. However, cumulative dividends tend to have a lower dividend rate of return
Optional Conversion (Preferred)	◔	• This term sheet provision gives the preferred stock investor the right to convert to common stock. This right is rarely utilized by investors in normal conditions as preferred stock has more value than the common stock at the time of liquidation. • However, depending on the terms of their liquidation preference, it may be financially beneficial to convert to common stock prior to a sale of the company. Second, preferred stock often doesn’t have the same voting rights as common. Preferred shareholders may therefore wish to convert to acquire these voting rights.

Equity term sheets typically include provisions that impact investment economics (2/2)

Term	Usage	Description

Liquidation Preference (Preferred)	●	• Liquidation preference determines who gets proceeds first and how much when the company is liquidated, sold, or declares bankruptcy. When distributing liquidation proceeds, preferred stock has the right to get a certain amount of money back before the common stock gets anything (the "preference.")
		  ○ Non-participating preferred stockholders get their initial investment, but they will not share in the liquidation proceeds based on the percentage with the common stocks
		  ○ Participating preferred stockholders will receive liquidation proceeds based on a percentage of the common stocks after receiving the initial investment
		  ○ Capped participation stockholders receive liquidation proceeds based on a percentage of the common stocks after receiving the initial investment up to a certain cap (multiple of investment)
		• Generally, liquidation preferences would be equal to the amount invested. However, at times, it would be a multiple of the amount invested. This multiple can be in the range of 3 to 5 times of the amount invested

Put Option	◔	• Put option may often be a suitable exit strategy for minority shareholders. Such an option allows the minority shareholder to require the company or the majority shareholder to purchase its equity upon certain terms and conditions. The company might be required to buy back its shares if there has not been an exit within a pre-determined period. The purchase price can often be calculated based on a formula that takes into account a designated financial measure (e.g., revenue, EBITDA) or other operational metrics. In addition, the multiple may be applied to such financial measures
Call Option	◔	• If the minority shareholder has interest to own more of the company, a call option can be structured whereby the minority shareholder would have the right to purchase the equity owned by the majority shareholder

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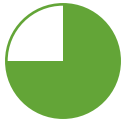
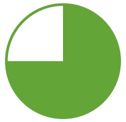
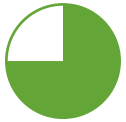
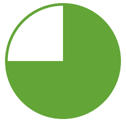
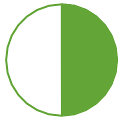
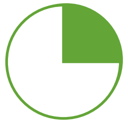
Equity term sheets typically include provisions that provide control rights and downside protection (1/3)

Term	Usage	Description
Board of Directors		• This clause deals with the number of directors that would be on the Board, from the investor side. Investors may negotiate control of part of the Board of Directors, generally to influence decision making and to protect their investments rather than to run the company
Information Rights		• Investors would typically require companies to provide "information rights". This sometimes includes direct access to the company's auditors and bankers. These contractually defined obligations typically include timely transmittal of annual financial statements (including audit requirements, if applicable), annual budgets, and audited monthly and quarterly financial statements
Reserved Matters/ Protective Provisions		• This is a list of important matters that need the consent of a certain percentage of shareholders in order to achieve alignment with the management of the company. Issuing new shares, selling the company or merging with another company are a few examples of such important decisions. The most common levels of approval include a) simple majority – 50%, b) supermajority – 75%+, c) unanimous decision
Transfer Restrictions		• Transfer restrictions are restrictions placed on transferability. These term sheet restrictions are placed to ensure that shares are not sold to a party which the company does not want as a shareholder

Equity term sheets typically include provisions that provide control rights and downside protection (2/3)

Term	Usage	Description
Tag Along Rights		• Tag Along Rights protect minority shareholders. These rights enable investors to sell their shares alongside certain other selling Shareholders in a potential private transaction to a third party, on the same terms, and in proportion to their relative ownership in the Issuer to the seller
Drag-along Rights		• Protects the Shareholders holding a majority of the issuer's equity. This enables the issuer to pursue certain strategic transactions, such as a sale of the company, if approved by a majority (or possibly super-majority) of all shareholders. Minority shareholders are forced to join the transaction at the same price and terms as other selling shareholders. To protect itself from being dragged into a less- than-ideal sale transaction, the minority shareholder should make the "drag-along" provision only upon approval by a supermajority of shareholders or only if the net proceeds of such sale will exceed a predetermined threshold amount
Rights of First Refusal		• This protective clause ensures that shares cannot be sold to an undesirable third party without first either allowing the company to find a purchaser or offering them to the other existing shareholders at the same price offered to that third party. If there is a dispute over the price of the shares, it is possible to provide for an independent valuation or a formula to determine the fair value. If the price is lower than what was offered, the shareholder may withdraw their notice to transfer the shares
Pre-emptive Rights		• Pre-emptive rights are those rights which give the shareholders a right to purchase new securities, if any, issued by the company. This term sheet provision is included in the term sheet so that investors can retain their relative percentage of total outstanding shares

Equity term sheets typically include provisions that provide control rights and downside protection (3/3)

Term	Usage	Description
Anti-dilution Provision		• Anti-dilution clauses which are similar to pre-emptive rights can be an additional protective measure for minority shareholders ensuring they do not see new shares issued at a lower price than the investors previously received. There are two kinds of anti-dilution provisions: the "weighted- average" provision and the "ratchet-based" provision. The weighted-average provision gives shareholders the right to purchase shares at a price that accounts for the change in the old and new offering prices The ratchet provision offers existing shareholders the right to buy shares at the new lower price.
Pay to Play		• In a pay-to-play provision, an investor must keep “paying” (participating pro ratably in future financings) in order to keep “playing”(not have his preferred stock converted to common stock) in the company. The pay-to-play provision impacts the economics of the deal by reducing liquidation preferences for the non-participating investors. It also impacts the control of the deal, as it reshuffles the future preferred shareholder base by ensuring only the committed investors continue to have preferred stock (and the corresponding rights).

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Mezzanine instruments are a hybrid of debt and equity financing

	Instrument	Description
Debt-like	Subordinated debt	Refer to loans with tailored repayment structure and flexibility regarding collateralization requirements. Payments to the investor are sculpted around a company's specific situation, often allowing for long grace periods or seasonality on principal repayments and interest payments. Typically has a cash coupon, payment in kind (PIK) component, and an optional equity kicker in the form of warrants or equity conversion
	Royalty based lending/Revenue sharing loans	Provides the investor with a payment dependent on the performance of the company, usually a percentage of revenue or EBIT(DA) typically until a certain return target is achieved. Often convertible into equity at pre-defined multiple with a capped return (e.g., ~3x). Convertible stake usually decreases with loan repayment
	Convertible loans	Usually, a subordinated loan with a maturity date and a regular repayment schedule, and an option to convert the loan into shares of the company at a fixed price. Sometimes a bullet payment is used if a company does not have sufficient cash flows early in its lifecycle
	Preference shares	Shares that have preference over ordinary shares, including priority in receipt of dividends and upon liquidation, often a fixed annual dividend
Equity-like	Redeemable equity	Mostly similar to ordinary shares, but with a right to sell the shares back to the entrepreneur (put option), typically using a predetermined price or a formula

Very often, the actual investment might be in the form of a hybrid of two or more instruments (e.g., variable debt + redeemable equity)

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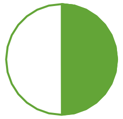
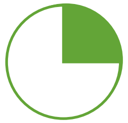
Mezzanine terms impacting investment economics are typically around the repayment of interest and principal (1/2)

Term	Usage	Subordinated Debt	Convertible Debt	Revenue Sharing Debt
Cash Interest	●	• Cash interest that typically follows a regular payment schedule (sometimes with an initial grace period). Usually a fixed rate, can also be in form of base rate plus a performance linked spread	• Coupon rates are typically lower than in subordinate debt • Can have a regular payment schedule (same structure as in subordinated debt). With early-stage start-ups, there is often no cash interest, the interest accrues to the principal	• Cash interest that typically follows a regular payment schedule (sometimes with an initial grace period). Usually a fixed rate, can also be in form of base rate plus a performance linked spread
Mandatory Repayment	●	• Subordinated debt is typically interest-only with no amortization prior to maturity	• Typically, a regular repayment schedule, often with initial grace period. Sometimes a bullet payment is used if company does not have sufficient cash flows early in its lifecycle	• Repayment is based on the % of revenue/net income/cash flow. Typically has a regular repayment until the repayment of 2-3x the original loan amount
Optional Prepayment	●	• Optional prepayments are typically made at low or declining premiums. For example, notes may be redeemed at 103% of their principal amount in the first year after issuance, 102% in the second year and 101% in the third year	• Investors in convertible debt generally will not permit prepayment since their return is highly dependent on the conversion to equity	• Revenue sharing loans typically have no prepayment penalty, and the company is often incentivized to repay the loan early.

Mezzanine terms impacting investment economics are typically around the repayment of interest and principal (2/2)

Term	Usage	Subordinated Debt	Convertible Debt	Revenue Sharing Debt
Warrants/ Equity Conversion		• Sometimes includes optional detached equity warrants that can have zero or very low exercise price, and represent least dilutive minority stake in issuer	• Includes an option to convert the loan into shares of the company at a fixed price	• Can often be convertible into equity at pre-defined multiple with a capped return (e.g., ~3x), convertible stake usually decreases with loan repayment
Payment in Kind (PIK) Interest		• PIK interest is not paid in cash but rather by increasing the principal amount through capitalization of the interest payment then due. Typically, 0 - 1.5% that accrues to the principal annually	• In rare cases PIK can be a part of the structure when the target company does not generate the short-term cash flow necessary to pay interest but has potential to generate sufficient long-term free cash flow (FCF) to service the debt	• Typically, doesn't include PIK interest

Mezzanine term sheets typically include provisions that provide control rights and downside protection

Credit pledge	• Pledges of shares of the borrower • Corporate / personal guarantees of the sponsor • Lien on fixed assets
Negative covenants	• Debt limits: impose an obligation on the borrower to maintain an equity to senior debt ratio above a level specified in advance under contract • Dividend tests: the prohibition on the payment of dividends above a pre-set amount without the prior approval of the mezzanine lender • Poisoned puts: protection against the risk of a re-leverage operation, enabling the mezzanine lender to impose its obligations on the issuer in the event of a change in control of the borrower • Prohibition on the conclusion of extraordinary financing operations (mergers and acquisitions, transfers of operations, corporate acquisitions etc.) without the prior approval of the mezzanine lender, as well as limitations on the award of bonuses to management and on the distribution of dividends in excess of certain limits
Affirmative covenants	• The obligation to maintain a minimum level of liquidity (current assets to current liabilities ratio) • Compliance with certain financial ratios specified under contract at the time the loan is drawn down • Covenants intended to ensure that cash flows will be used in order to accelerate repayment of the loan in the event of scenarios which are more favorable than those projected
Control provisions	• Mezzanine lenders may request certain forms of control over company decision making and appoint one or more directors to the board of the company

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Term sheets are often misconceived as complex, rigid, legally binding documents

Misconception	Fact
No terms can be changed once a term sheet is signed	• Commercial terms might be adjusted • Deal might change given application of the law, lenders requirements etc.
Term sheets are legally binding	• Whereas term sheets are not generally intended to be legally binding, parties can agree to make certain clauses (commonly those dealing with confidentiality, exclusivity and sometimes costs and break fees), binding
Term sheets have a standard structure	• Whereas there are no standard term sheets, some clauses are standard and included in most term sheets
Level of detail contained in term sheet	• The level of detail contained in a term sheets varies. Some may need to be very comprehensive while some can be very high level depending on the nature of the deal and the dynamics between the involved parties
Term sheets are required in every transaction	• Some transactions do not require a term sheet e.g., where the financier has a good understanding of the project or where the financing structure is standard e.g., with commercial bank loans
Term sheets can only be drafted by a legal professional	• Term sheets do not need to be drafted by legal professionals but act a template from which legal professionals can draft definitive legal agreements
Term sheets are only used for equity transactions	• Term sheets are used for different types of instrument financing including equity, debt and mezzanine instruments

Q&A Session

Thank you!

Please email dealroom@agra.org if you have any follow up questions