# The Art of the Deal (Negotiating a Term Sheet)

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I remember reading Donald Trump's *The Art of the Deal* when it came out more than 20 years ago. I was curious how Trump had managed to put together his vast real estate empire at such a young age. During my business career, I've been fascinated with deal-making and how to negotiate win-win opportunities. I'm convinced that even when you're on the winning side of a win-lose deal, it's ultimately still a loser most of the time. In this column series, we've been looking at how to negotiate a term sheet for an investment. My premise is that most physicians are routinely approached to participate in a variety of business "deals." For those entrepreneurially-minded physicians that want to participate in such deals, they're well served to understand the fundamentals of deal negotiating to help build a solid investment portfolio. In last month's column, I reviewed some of the "big rocks" of negotiating a deal, including whether the opportunity would be an equity investment, a debt investment, or some combination thereof. In this column, I'll review other key parts of a term sheet.

## Valuation

If you're investing cash in exchange for stock in a company, then you'll need to address valuation. In other words, what is the company worth, and how much stock are you getting for your cash investment? If there are historical financials, then you can usually base the valuation on a multiple of the annual earnings of the company before interest, taxes, depreciation, and amortization (EBITDA). The typical valuation range would be three to seven times the prior year's EBITDA. Alternatively, in some industries, company valuations are based on a multiple of the trailing 12 months' revenue. I also like to look at publicly traded companies in the same industry and see how they're valued to give me some indication of valuation. If there are no historical financials, then the company will likely be seeking investment based on future projections. This model will usually contain a discounted cash flow (DCF) valuation of the company's future earnings. As one investor I know has said, "I've never seen a pro-forma I didn't like." His sarcastic comment was describing the fact that most business projections have a smooth upward trajectory and often have a "hockey stick" in the later years that show large profits in the future. The reality is that most start-ups will fail. Even conservative pro-formas contain a degree of risk that must be accounted for. The bottom line is that valuation is both art and science, particularly for a start-up company. You need to factor in the risk of the deal and the desired return you hope to achieve. Remember, this is a key negotiable point in the deal and will have a long-term impact on your investment and return.

## Anti-Dilution

Once you've haggled your way into the valuation you want for your investment, one of the next things to consider is anti-dilution protection. Most growing companies are starved for cash. So if the company you just invested in needs additional money, then what happens if they take additional investment at a lower valuation than what you paid? If the company is struggling, then this could be a real possibility, which could have a dilutive effect on your investment. As an investor, you want to protect yourself from this by asking for what is known as "full ratchet" anti-dilution protection. While technical in the detail, this provision will essentially make you whole in the event the company sells stock in a "down round" for less than what you paid for your stock. The company may want to limit how long this would apply or may try to get you to agree to what is called “weighted average” dilution protection. Again, this is technical in detail and comes in two forms–broad-based and narrow, but the gist of it is that you get some anti-dilution protection with this type provision, but you are *not* made whole.

**Control**

This is a tough one. The founders of the company are going to want to keep it, and the investor is going to want to have some control as well. Of course, the amount of control depends on the level of the investment. As an investor, you want to make sure that your money is being spent wisely. From the company’s or founder’s perspective, they don’t want you as the investor micro-managing the business. Control issues are usually resolved by addressing representation on a board of directors or similar governing body of the organization. They are also addressed by spelling out certain items that need approval of the investors. For example, senior executive salaries, mergers, acquisitions, new debt, and future fundraisers are just some of the possible areas in which the investor will want to have a say. A well-functioning company has a good check-and-balance system between management and the board, and the board and the shareholders. Bottom line, as an investor, you need to make sure that your voice is heard and that there’s a proper balance of power and control in the organization.

Valuation, anti-dilution, and control are three big issues to consider as you do your deal-making. Your negotiating ability will depend on the age-old concept of supply and demand. If you have cash to supply when a company is in great demand for cash, then you’ll have significant negotiating leverage. However, be careful of “deal momentum,” which can lead to bad deals. As Nancy Reagan used to say, “just say no” is sometimes the best answer if the deal terms do not line up properly. While your potential investment may be the next Google, odds are it won’t. As I’ll discuss further in future columns, the key is to think like a venture capitalist and remember that there will always be another deal.