#DecodeYourTermsheet

Exit Rights

Reading a Termsheet for the first time (or even if it's not the first time) can be stressful. It is filled with legal jargon and clauses that founders may not fully understand. At times, we have seen funding fall through due to differences in terms, and not commercials.

#DecodeYourTermsheet is our series to make it easy for founders to understand standard terms and negotiations with VCs. The more you understand the termsheet, the easier it will be to close funding faster and manage the process more smoothly and cost effectively.

In each post, we will take one section of the termsheet and dive deep into it.

Here, let's talk about Exit Rights.

What are Exit Rights?

All VCs have a fixed time horizon, usually 10-12 years, to create liquidity for their own investors (called Limited Partners). Just like how any investment has an entry and exit period, a VC also needs to exit their investments and fulfill their LP obligations as per the fund lifecycle. Hence, including exit rights as a part of an investment termsheet is a standard norm.

Understanding exit rights can help founders get to a faster closure on their termsheet. Exit rights should not be a deal breaker, and an acceptable middle ground can be found.

Exits can be facilitated via the following common routes:

IPO & Strategic Sale

Secondary Transactions

Buy Back

Drag Along

Here's how Exit Rights appears in your Termsheet

The Company and the Founders shall make best efforts to provide a complete exit to the investors (i) through any mechanism (or combination thereof) acceptable to the Major Investor (ii) at a valuation and on terms acceptable to the Major Investor.

The Company and the Founders shall make best efforts to provide an Exit to the Investors prior to the Exit Date.

The Founders and the Company shall (i) do all acts and deeds required to effectuate the Exit including cooperating in any due diligence, sharing the necessary information, and providing representation, warranties and indemnities usually provided for transaction of such nature; (ii) co-operate with the Investors in obtaining all relevant approvals, statutory or otherwise, that are necessary for the consummation of the Exit; and (iii) bear all costs and expenses in relation to the Exit.

IPO & Strategic Sale

IPO (Initial Public Offering) is the cleanest path to exit. This is when the company lists on the public markets either through the issuance of new shares or an offer to sell existing shares in the company to the public. The investors' shares get converted to common shares in the event of an IPO and they will have their own norms on how much they can exit or not.

IPO is the simplest term to negotiate, and the only point of discussion may be the approval process to decide on the timing of the IPO.

A strategic sale is when the startup gets acquired by a larger company or organization. This can either be through an all-cash deal, a complete share swap, or a mix of cash and share swap. A strategic sale is more complicated and conflict prone in aligning all your shareholders.

Kalaari Perspective

Usually by the time a startup reaches a stage when an IPO or strategic sale can be considered as a preferred exit option, the cap table will likely have a large investor base.

Any exit and their terms will require investor consent, and it is important that the **consent mechanism is based on an investor-majority construct and no single investor should have veto powers.** The majority construct can be based on investor shareholding thresholds or a certain number of major investors or a combination of both. This construct varies on a case-to-case basis.

It's important for founders that the decision-making process is not crippled by a few dissenting shareholders and/or is not forced by the decision of a few shareholders.

Secondary Transactions

Financial investors typically have the right to sell their shares to a third party at any time they deem fit.

Usually, these independent secondary sales are structured along with the primary investment by a Private Equity firm or growth stage investors.

Kalaari Perspective

Secondary sales are a good option for investors. **It's important for founders to ensure that investors are not dumping their shares at the wrong price or the wrong time.** While there may not be a lot of room to negotiate this, having constructive shareholder relationship ensures that there is rarely disagreement on this.

In larger companies, it's possible to ask for board approval to facilitate secondary sales. However, earlier the stage of the company, this is less negotiable.

Buy Back

If the company is not able to provide an exit to their investors prior to the exit date, it may be required to buy back the shares from the investors at the FMV (Fair Market Value) or commercially agreed upon price.

Companies undertaking Buy Backs need to comply with certain thresholds and limits specified under applicable laws. Therefore, the Buy Back structure (in terms of how many shares can be bought back and how much capital can be used for the buy back) is decided on a case-to-case basis.

Kalaari Perspective

Buy Back is very complicated and most often not viable to execute in the startup construct.

Most companies will typically fall under one of three buckets: a) growing and scaling rapidly b) facing critical issues and is likely to shut down c) company is generating cash flow and growing but is not able to scale fast enough to be able to either raise follow on rounds or get acquired.

In the first two situations, it's unlikely that any investor will look to exercise this option. However, in the third case, Buy Back can emerge as one of the feasible options for the company to facilitate an exit to the investor.

Buy Backs are not exercised often, and it is not worth fighting over due to the practical impediments in exercising it.

Drag Along

If the company has failed to provide an exit to the investors prior to the exit date or if there is an event of default, the Drag Along right allows the majority investor(s) to sell their shares to a third party acquirer and force the remaining shareholders (including the founders & any other minority shareholders) to sell a part or all their shares to such incoming acquirer if the buyer wants to achieve a certain target shareholding percentage.

Drag Along enables the majority investors to sell their shares to a potential acquirer without being held back by minority shareholders who may have different interests or priorities.

Kalaari Perspective

Drag Along can be seen as a controversial term by founders. **Drag event is an outlier situation** when everything else breaks down, and it is not possible for the investor to continue holding shares in the company any longer. In reality, **we have rarely seen drag along being enforced by investors** and Kalaari has never dragged any company. Given the practical impediments in enforcing a Drag Along, it may be worth for founders to take a pragmatic approach towards understanding the necessity for having a Drag Along right and not delay deal closure on account of this clause.

Instead, **founders can look to build in certain safeguards and thresholds to ensure that the Drag Along right is available to only major investors and not the minor investors or angels.**

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About Kalaari Capital

Kalaari Capital is an early-stage, technology-focused venture capital firm based in Bengaluru, India. Since 2006, Kalaari has empowered visionary entrepreneurs building unique solutions that reshape the way Indians live, work, consume and transact.

The firm's ethos is to partner early with founders and work with them to navigate the inevitable challenges of fostering ideas into successful businesses. At its core, Kalaari believes in building long-term relationships based on trust, transparency, authenticity, and respect.

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