Cap Table Basics

Jason Jones and Michael Umansky

Equity Securities

- A **capitalization table** (or cap table) is a spreadsheet or table that shows the equity capitalization for a company.
- **Common stock** is generally the most junior ownership interest in a corporation. In the event of liquidation, common shareholders get paid last.
- **Convertible preferred stock** is a class of preferred stock that include an option for the holder to convert the shares into common stock. In venture capital financings, the most common security is Convertible Preferred Stock.
- Usually, each "round" of financing involves the sale of a newly created security. These are customarily named "Series Seed," "Series A," "Series B," etc. The rights, preferences, and privileges of each class are negotiated (and re-negotiated) in each round.

More Key Terms

- **Issued and outstanding** refers to the actual shares of a company issued and does not include unexercised options or warrants, unissued shares reserved under an equity plan, or unconverted SAFEs or convertible notes.
- **Fully-diluted** refers to the capitalization of the Company if all options and warrants were exercised and (sometimes) if all SAFEs and convertible notes were converted.

Features of Preferred Stock

- A **liquidation preference** refers to the order of payment in the event of a liquidation event.
- **Participating Preferred** shares get a liquidation preference in the event of a liquidation event, and any money left over is divided equally among the Common and Preferred.
- **Non-Participating Preferred** shares also get a liquidation preference, but if that preference is paid, all of the proceeds are divided among common and preferred on a pro rata basis.

Features of Preferred Stock

- **Example:** If the preferred holders owned 50% of a company and had a liquidation preference of $100k, and the company sold for $1,000,000:
  - If participating preferred, the preferred holders would receive $100k plus 50% of the remaining $900,000 (i.e., $550k total)
  - If non-participating preferred, the preferred holders would receive 50% of the total $1,000,000 (i.e., $500k total) since the liquidation preference was satisfied.

Features of Preferred Stock

- **Pari passu** means different series of preferred stock are treated the same for purposes of a particular calculation.
- If not pari passu, series of preferred are referred to as “junior” and “senior” vis-à-vis other series.
- **Anti-dilution protection** is a mechanism that protects stockholders from dilution in the event of a “down round.”

Pools

- An **option plan** is a pool of shares reserved for issuance as compensation to service providers.
- **Issued stock** from the plan are shares actually issued (either as awards of stock, or as a result of the exercise of granted options), under the company's stock option plan (and reduce the amount available for issuance).
- **Options** issued under the plan are options to purchase shares and are issued under the pool. Holders are not stockholders and do not vote unless and until they exercise their stock options.
- **Unissued plan shares** are shares reserved under the pool that are not yet issued. These shares are included in the Company's "fully-diluted capitalization"

Convertible Instruments

- **SAFE** stands for Simple Agreement For Future Equity. It is a contract for future equity based on an investment made when the SAFE is signed. SAFEs are viewed as more investor-friendly alternatives to convertible notes, and give investors the right to equity upon certain triggering events. SAFEs bear no interest and do not "mature" like traditional convertible notes. They convert into the next qualifying equity financing at a price based on a set discount rate, a valuation cap calculated price, or at no discount, depending on the type of SAFE used.

Convertible Instruments

- A **convertible note** is a debt instrument often issued to friends and family or angel or seed investors looking to fund an early stage startup which has not been valued explicitly. Convertible notes accrue interest either become due and payable on the maturity date or convert upon certain triggering events, such as a qualified equity financing, a discount based on a set discount rate or a valuation cap.

- A **discount** is a common feature of convertible notes and SAFEs that provide holders a lower price per share (often by 10%-25%) than purchasers of newly issued securities.
- The **Valuation Cap** is a common feature of convertible notes and SAFEs. Like a percentage discount described above, a Valuation Cap provides holders of these instruments a lower conversion price than the purchasers of newly issued securities. The price per share is determined by dividing a negotiated "pre-money valuation cap" by the number of shares of the Company on the date of conversion. The bigger the gap between your Valuation Cap and the actual pre-money valuation in the next equity raise will result in a bigger discount.

Pro Forma

- A **term sheet** sets forth the basic terms and conditions of a proposed offering of debt or equity. A term sheet can be binding or non-binding. Once agreed upon, definitive documents are drafted.
- **Pre-money valuation** is the company's negotiated enterprise value before it receives investments such as external funding or financing.
- **Post-money valuation** is the company's negotiated enterprise value after it receives the applicable investment. Usually, the post-money valuation is equal to the pre-money valuation plus the amount of any new equity received from investors, although it may be a bit more complicated if there are any discounts (e.g., in connection with the conversion of a convertible note).

Pro Forma

- A **down round** is a preferred stock financing that results in a lower price per share than the securities sold in a prior round. In other words, the pre-money valuation of the new round would be lower than the post-money valuation in the most recent round, or there has been dilution without a corresponding increase in valuation.