Understanding Your Capital Structure

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Introduction

- Goals of Presentation
  - Provide an overview of a capitalization table for a corporation
  - Explore the dilutive effect of option awards and other equity issuances
  - Discuss how financing rounds and other events affect founders’ equity

Anatomy of a Cap Table

- A capitalization table sets forth all of the outstanding equity or ownership interests in a company, as well as all rights to acquire any additional equity interests, as of a fixed point in time.
  - Common Stock
  - Preferred Stock
  - Options and Convertible Securities
    - Equity Incentive Plans
    - Convertible Debt
    - SAFEs
  - Capitalization table vs. stock ledger

Equity Incentive Plans Generally

- All equity incentive plans include a “reserve” or “option pool,” which represents the maximum number of shares of common stock (or options to purchase common stock) that the company may grant to its employees, consultants or other service providers.
  - Awards are typically subject to vesting schedules, such that upon the service provider’s termination all or a portion of the number of shares underlying such award are cancelled.
  - The number of shares cancelled return to the reserve, increasing the total number of shares that the board of directors is authorized to grant.
  - The reserve is calculated as the total number of shares authorized in the plan, *minus* the total number that have been granted, *plus* the number that have been cancelled.
  - Board and stockholder approval are required to increase the number of shares authorized under an equity incentive plan.

Anatomy of a Pro Forma Cap Table

- A “pro forma” capitalization table is designed to show the impact of a proposed transaction (usually an equity financing) on the overall equity ownership of the company.
- Key Components of a Pro Forma Cap Table for an Equity Financing:
  - Pre-money Valuation vs. Post-money Valuation
    - Post-money valuation is the pre-money valuation plus the new money invested
  - Fully-Diluted Capitalization
    - Increase in reserve for Option Plan
    - Impact of convertible debt and SAFE’s (i.e. discounts, caps, etc.)
  - Share pricing for the equity financing is determined by dividing the Pre-money Valuation by the Fully-Diluted Capitalization.
  - The “Golden Rule”
    - ***(DOLLARS INVESTED / POST-MONEY VALUATION) = (SHARES ISSUED / POST-MONEY FULLY-DILUTED CAPITALIZATION)***

Preferred Stock – Anti-Dilution Protection

- Price-based anti-dilution protection
  - One of the most common rights given to investors participating in a preferred stock equity financing.
  - Share of preferred stock initially convert to common stock on a 1:1 basis.
  - Anti-dilution formulas change the conversion ratio of that series of preferred stock into common stock.
- A "down round" refers to an equity financing where the pre-money valuation agreed to by the investor and the company is lower than the post-money valuation of any prior round of equity financing.
  - Down rounds trigger the anti-dilution protections for previous series of preferred stock.

Preferred Stock – Liquidation Preference

- Another of the most common rights given to investors participating in a preferred stock equity financing is a liquidation preference.
  - A charter typically provides that holders of preferred stock are entitled to receive an amount equal to some multiple (*e.g.*, 1x) of their original purchase price before holders of common stock are entitled to receive any consideration in a liquidation event.
  - Liquidation preferences can be used by investors as a defensive (ensure return of capital) or offensive (ensure minimum gains) measure.
  - The most recently issued series of preferred stock generally is “on top” of the liquidation preference stack and is entitled to receive its preference amount before holders of any earlier series of preferred stock receive their preference amounts.
  - Multiple classes or series of stock may be *pari passu*, meaning that they are on the same level of priority in the preference stack.

Liquidation Preferences

- Types of Liquidation Preferences
  - *Non-Participating* – Holders of preferred stock are entitled to receive ***either*** their preference amount ***or*** the amount they would receive if their preferred stock converted to common stock, ***but not both***.
  - *Participating with No Cap* – Holders of preferred stock are entitled to receive ***both*** their preference amount ***and*** the amount per share that common stockholders are receiving, ***without any limit***.
  - *Participating with a Cap* – Holders of preferred stock are entitled to receive ***both*** their preference amount ***and*** the amount per share that common stockholders are receiving, ***but only up to limit*** typically set at some multiple (*e.g.*, 3x) of their preference amount.