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Are cap tables a challenge?

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Author: Liliana Korosi

The capitalization table (cap table) has become a useful tool for start-ups to track the company's capitalization, especially in preparation for financing. Although used widely, the cap table may prove to be challenging. A constantly evolving work in progress, a cap table may be tamed by using a well-structured layout.

Purpose and use

- A cap table (i) outlines equity ownership and voting percentages and (ii) assists the management team as well as the board of directors in the decision-making process to run different scenarios depending on the pre-money/post-money valuations, option pool targets, different financing round sizes, etc.
- Basically, a cap table is a list of the company's securities and their current and prospective holders.
- A cap table helps
    - assess whether the company has sufficient shares available for the option pool
    - determine how dilutive a new option grant would be to the other shareholders or how a new round of financing would be for the founders and the other shareholders
    - calculate the exact number of shares to be issued to an investor to reach its requested percentage into the company
- ensure tax and regulation compliance

Form

- There are several ways to prepare and maintain a cap table; for early-stage companies it's usually an Excel spreadsheet.
- A cap table is a working tool for the company and its management team, and all should use the same one, with multiple spreadsheets if necessary, to respond to the various needs at different stages:
    - reflecting the company's corporate structure
    - tax purposes
    - company's valuation
    - reflecting the company's previous and/or future financing rounds
    - preparing for a shareholders' meeting

- More elaborate systems are being used, usually as the company reaches the Series A financing stage, such as Carta cap table management.
    - Carta promotes its cap table management software as a tool that provides automatic updates when you issue electronic securities, raise a round or determine a company valuation.

Approach

- Regardless of the form or the various uses, the information reflected in the cap table should be consistent with the company's current corporate documentation (corporate books and ledgers, shareholders agreements, option grants and agreements, financing documentation).
- A cap table should be
    - simple, easy to use
    - reflecting the most recent information collected from the company's corporate documentation
    - constantly updated to reflect the current corporate documentation
    - using full names for individuals and entities
        - use the full legal name of the shareholder that is an entity and not the name of such shareholder's principal
        - if you need to identify the principal or main contact for your shareholders, include a separate column/spreadsheet
    - containing a legend for all the acronyms used to define certain terms
    - using defined terms consistently throughout

Main items

- A cap table lists
    - the company's securities and their holders:
        - types of securities issued/granted/vested (shares, options, warrants, convertible debentures, SAFEs, KISS)
        - issue and grant date, complete vesting schedules
        - name of each securities holder, and the number and type of securities held by each
        - total number of authorized shares (including per class or series, as applicable)
        - total number of issued and outstanding shares on a fully diluted and non-fully diluted basis (basic)
        - purchase price paid per share by each shareholder or the amount of the investment made by each securities holder
        - conversion formulas and mechanisms
    - pre-money and/or post-money valuation calculations/numbers
    - options reserved pool
    - ownership, control, voting and participation percentage in the company
    - various approval thresholds
    - percentages for participation under power of attorney/proxy (helpful especially if/when used to determine quorum during shareholders' annual or special meetings)

- If the corporate documents (shareholders agreement, articles of incorporation) require certain specific approval/voting thresholds (e.g., special overall majorities or specific class/series of shares majorities, etc.), the cap table should include columns that separately show the percentage held by each shareholder that should/could be covered by such thresholds. This way, the company will be able to easily determine who to target to obtain such approval/voting thresholds.

Value of the company

- Determining how much the company is worth may prove to be rather difficult, especially when the company is based on a good idea but few assets (like most biotech, life science or AI start-ups). In such cases, valuation becomes a subject of negotiation between the company and the investors.
- A well-structured cap table may assist in running different valuation scenarios to assess the dilution effect of a new round of financing.
- The angel investors community has developed methods that are commonly used by early-stage companies to determine valuations.
- Using a blend of methods (rather than relying on just one), which combine a variety of factors, is recommended:
    - entrepreneur's business track record
    - business and management teams' experience
    - product development stage
        - For example, the existence of a prototype reduces the technology risks. The further the product is in the development process, the lower the product risks (need for regulatory approvals, the clinical trial requirements, etc.).
    - strategic relationships
    - advantages over the competition
    - sales channels
    - market size
    - potential derivatives products
    - expansion of the field of use or industry applicability

Pre-money valuation

- Pre-money valuation refers to the value of the company not including external funding or the latest round of funding.
- Pre-money is best described as how much a start-up might be worth before it begins to receive any investments.
- This valuation gives investors an idea of the current value of the business, while providing the value of each issued share.
- Some founders opt to ignore any form of valuation process and simply place a pre-money valuation on their company after deciding how much of the company they are willing to give up in exchange for the investment they need; the downside to this approach is that it is offering an unrealistic valuation.
- Where possible, it may be useful to see what companies with similar businesses, which

have completed investment rounds, have used as a pre-money valuation number.

Post-money valuation

- Post-money refers to how much the company is worth after it receives investments.
- Post-money = pre-money valuation + money received during the investment round.
- Post-money valuations are simpler because the valuation of the business is fixed, whereas in a pre-money scenario, the value of the business evolves depending on several variables, such as the options pool, convertible securities (convertible debentures, SAFE, KISS) and anti-dilution rights. These instruments are usually added to the post-money valuation at the time of investment.
- The company valuation method affects the ownership percentages and is a major negotiation point between the company and the investors.