Capitalization Table White Paper

What is it and why is it so important?

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What is a Capitalization Table (or "CAP table") and what does it say about the Company? Or, in other words… How do Entrepreneurs mess up their CAP tables without even knowing they have done something that can be extremely harmful? Entrepreneurs are often confused when a potential investor asks to see their CAP table. We have observed that many entrepreneurs aren't exactly sure what a CAP table is and, even if they do, they're not quite sure why an investor would want to see it.

The Cap table is the tool that companies use to illustrate to investors the prior capital raise, the allocation for employee stock plans and any commitments for shares in exchange for services. If not documented correctly prior to an investment, it can lead to costly legal fees and potential lawsuits that can completely derail otherwise promising companies. This is an area that can create tremendous problems for the unknowing investor *and the entrepreneur* that does not understand the importance of a well-documented CAP table. Equally important is how did the founders create a valuation for the basis of the funding raise.

These reactions demonstrate a lack of appreciation for this critical, and often misunderstood document. Why is this document so important to investors? First, a CAP table is supposed to be THE document that shows *who owns the company and what they paid to attain that ownership and how much is the company currently worth*. But, in their attempts to achieve that objective, founders can make a few common mistakes:

- Taking money from investors without using the proper paperwork;
- Failing to document ALL shares that have been committed by the company (including those promised, gifted, optioned, accrued, etc);
- Failing to establish an employee option pool BEFORE the investors invest;
- Failing to document the rationale for the pricing of *each and every round* of stock sold in the company;
- Conducting "off CAP table" transactions that are not documented and explained.

No other issue will lead to more suspicion and mistrust by a potential investor than to discover discrepancies on the CAP table. For the early stage company, it is an Enron-sized mistake and likely to cause the founders and investors to settle things in court. Tip of the day: attorneys are expensive!

Why is the CAP table so important? Because, if the investor believes in your value proposition, then the biggest question is in "who owns stock in your company, and how much do they own." If the investor discovers all sorts of people "coming out of the woodwork" with claims to stock that was not listed on the CAP table they invested in, lawsuits will fly.

So, let's look at some of the more common issues and see why they can be viewed as a problem.

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CAP Table Mistakes

1. *Missing or Improper Paperwork.* Every investor must sign SEC approved paperwork when they invest. The biggest issue here is to verify that your investors are "Accredited" as defined by SEC guidelines when raising capital under one of the programs that require that level of investor. Remember, it does not matter what guideline the business is applying to the investor, they still must have paperwork documenting the level of investor based on income. For the official definition of an Accredited investor, please refer to the Securities and Exchange Commission definition here.

   To quote from the S.E.C.'s website, "*Under the federal securities laws, only persons who are accredited investors may participate in certain securities offerings. One reason these offerings are limited to accredited investors is to ensure that all participating investors are financially sophisticated and able to fend for themselves or sustain the risk of loss, thus rendering unnecessary the protections that come from a registered offering*."

   It is always possible that when you go to a subsequent round with a venture capitalist, they will want to see that all current investors are accredited. Also, while uncommon, the Securities and Exchange Commission might get nosey and start asking for proof that your investors are accredited. Avoid these potential problems as if they are contaminated with the plague.

2. *Missing Shares*. Entrepreneurs sometimes think they can just promise shares to anyone and not keep a record of those transactions. We have seen entrepreneurs regularly promise shares to relatives, employees and consultants without making a record of it in their CAP table. Then, guess what, they forget what they did!

   But, guess again, the person to whom the promise was made does NOT! Verbal agreements have been known to be upheld (especially if there were witnesses) and many companies have lost a lot of money on shares they never knew were allocated. Such occurrences do not sit well with the shareholders.

3. *Employee Option Pools*. Usually, a good advisor will suggest that a growing company set aside 10-15% of their stock as an Employee Option Pool to help provide incentive rewards to current and future employees. If these shares are not allocated until *after the current investment round*, then the investors will suffer a large and unnecessary dilution. The experienced investor will not make that sort of mistake and your raise will likely fall short of your financial goal.

4. *Share Price Justification*. Shortly after the company was founded, the entrepreneurs decide to "raise some cash" to grow it. How did they price their shares then and how are they pricing them now? What valuation will they use? The key here is in documenting WHY the price and valuation (whatever it is) is justified. In a subsequent section we discuss some of the valuation concepts that you will absolutely need to be aware of. Some entrepreneurs believe they can go from an idea to a $100 MM valuation is just a couple of months. Not likely.

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Then, to complicate matters, suppose when they first got started the set the price at $2 and found it easy, so they decide to bump up the price mid-way through the round. How do you explain to the guy buying stock this week for $3.50 that he could have had it for $2.00 last week? The problem is that at some point in the future, the investors discover that they paid a different price within the round and insufficient information is provided to warrant the price change, so they issue a challenge.

A *shareholder challenge* will impact all the shareholders because the SEC could investigate, discover the discrepancies and require the company to pay back money it doesn't have to establish equal value to all the shareholders. Also, your sophisticated investors might just make a call to their attorney and file suit. If you want to avoid this type of shareholder challenge, the best "rule of thumb" is to have a 60-90 day "quiet period" (where no shares are sold) before raising the price AND a well-documented CAP table with updated language showing milestones accomplished that warrant an increase in share price and overall value of the company.

5. *Off CAP table transactions*. It is not unusual for an entrepreneur to incur debt in their company nor is it unusual for them to agree to convert this debt into equity. That type of early debt is referred to as "Convertible Notes" – the "convertible" term means it will convert into either preferred or common shares down the road, and the "note" term means it is a loan, with a maturity and an interest rate.

   The problem occurs when the entrepreneur tries to cut a deal by converting their debt at a "better than market rate price" and then burying it somewhere in the financials. The CAP table just adds the shares in without reflecting the price. This is called an "off the CAP table" transaction and, at best, it is deceptive. This where your corporate counsel will earn their high hourly fees, by recommending that you not make this sort of a deal.

   Also, the company could offer an accountant review of the startup capital spent and whether it's documented as a personal loan to the company or as startup equity. Sometimes the Founder will say they have invested XX dollars into the company and therefore justifies their equity share and potentially anti-dilution clauses, but also put the money on the balance sheet as long term debt. You can't have it both ways. It's either equity or debt, not both!

The Solution

The solution is to understand what constitutes a credible CAP table *to an investor*. The CAP table should be easy to understand, well documented, and complete. This is the first step in establishing the mandatory basic level of trust required between the company and the investors. Here are a few tips on how to avoid the problems we just discussed:

1. *Create a Corporate Investor Logbook*. All shares that are bought, distributed, promised, gifted, optioned, and so forth are recorded in it. It should have a record of the type and class of stock (i.e., Preferred or common), the date(s) of the transaction(s), any price *or consideration* being received for the value of the stock, any terms that would define the transaction (or a reference to a contract that will define the terms) and finally, dates under which this transaction is bound. (The term “consideration” is a legal concept that refers to something of value – think of a consultant providing advice in exchange for shares.) Ask your counsel to keep this document. They will ensure its up to date and accurate. While we’re talking about the attorney, please ensure that they have ample experience with securities law!

2. *Record all transactions into the official CAP table*. When any allocation is made or promised, it should be recorded onto the CAP table, with a reference to the logbook and a record of transfers of all shares from the remaining authorized, but unallocated, pool of shares to the person or entity being recorded.

3. *Involve the Corporate Attorney*. Even in the event the company is using a Transfer Agent to manage a raise, a corporate attorney should be used to set up the initial structure and provide that to the licensed Transfer Agent for the management and distribution of stock certificates. Remember this one important fact: all sales of securities fall under the joint purview of the state securities division *and* the federal Securities and Exchange Commission. It is very easy to run afoul of securities laws (and the regulators have no sense of humor if you do) so please use an experienced securities attorney.

   The entrepreneur’s team, even the CFO if they have one, *should NEVER randomly issue a stock certificate without the advice of counsel*. Often the company may be issuing stock certificates as investment comes in and conveying that to the attorney or the transfer agent to batch issue all certificates at the end of the month or quarter. Counsel will make sure the company uses the proper paperwork and they also will keep their own logbook of all certificates that have been issued.

4. *Use the proper format*. Most CAP tables we see are not formatted properly. A good CAP table is NOT just a listing of all shareholders with the number of shares they own and the percentage those shares reflect. A good CAP table tells the corporate financial story. It is an annotated table spelling out the chronological growth of the company. It is divided into a series of columns, each of which represents a significant event in the life of the company.

5. Refer to the sample CAP table at the end of this document as you read through these items.

   a. Section #1 should maintain a running list of all shareholders presented *in the order* they received stock in the company.

   b. Section #2 should list how the company was originally divided among the founders of the company. If there is just one founder owning 100% of the company, there will be only one entry in this column. Section #2 should have three sub-columns. One records the date each founder made their contribution. A second records the capital investment made by the founder(s) to establish the company. The third lists each founder's stock allocation. At the Top of Section #2, should be the heading "Founder's Round" indicating that this was the first place where stock ownership was declared.

      It also should be noted that the shares allocated were "Founder's Common." Finally, the official date the company was founded should be listed at the top of this section. A series of annotations are usually added to explain the entries by footnoting them on the CAP table or on another sheet.

      NOTE: The CAP table will also tell the story if the company originated in a different form and was converted or 'merged' with the current company and a group of shareholders come in as one entity. If you see this, ask for the minutes and the record of the shareholder approval for that transaction so that you are walking into a future litigation mess.

   c. At the bottom of Section #2, the total dollar capitalization of the company should be added up along with the total number of shares. Then, the following notations should be made:

      i. Founder's Share Unit Price Value = $XXX

      ii. Estimated Valuation of the Company @ Founding = $YYY (Note: This value should be annotated with an explanation as to why you feel a certain valuation was justified on "Day #1." It may be high because of the quality of the team, the IP you have already developed and/or the customer base you know you can attain. Or, it might be low because, basically, all you have on Day #1 is an idea.)

      iii. The revised unit price value per share based on the above valuation (i.e., take the new valuation and divide by the total number of shares. This new price per share will act as a reference point for the next round of funding).

   d. Section #3 is the ideal place to expand the number of shares in the company and create an employee option pool. A company can do this at any time, however, if they are going to need people, vendors, board members or anyone else to help get this company off the ground AND, in lieu of payment, they are going to want them to accept stock, therefore Section #3 needs to be done ASAP.

We recommend that, for an option pool to have an adequate number of shares, approximately 10-15% of the total shares should be set aside for the Option Pool. Clearly, if the option pool was not established *prior* to the first round of investment, after these shares are added, all the founders will have a smaller percent ownership in the company. This is called founders dilution because the current investors will not be happy to hear that you're going to reduce their percentage of the ownership.

e. From Section #3 on, the content of each new section may vary, depending on the route the company takes. For example, the company's board or executive team may decide to raise a small amount of money via a "Friends and Family" round or a Series A expansion round.

   Or, they might have one of the founder's (or a vendor, or an angel) convert some of their accrued debt into equity. At some time in the future, they may add more shares into the Option Pool, or they might sell a portion of the company to a "strategic investor." Whatever the case, the key point is that it needs to be documented.

f. Here's a few more thoughts to consider when taking an action that affects the CAP table and any outstanding stocks. The CAP table should:

   i. Indicate the pre-money valuation of the company at the bottom of the section for this event. If the pre-money valuation is NOT the same as the post-money valuation from the last time they raised money (it almost always will NOT be the same because we hope the company has gained in value), then annotate (a) the rationale for why this new valuation is used by management and (b) what milestones have been achieved in the time period since the last investment.

   ii. Indicate the unit price per share that was charged in the round. (Again, this is a simple formula of just dividing the pre-money valuation by the total shares allocated BEFORE any money was accepted.)

   iii. Indicate the post-money valuation (which will be the sum of the pre-money valuation plus ALL the money raised in this round). This value is simply for reference. By the time the company wants to raise another round, hopefully new milestones will have been reached that will justify a new, even higher valuation.

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Setting Fair Valuations

Since setting a reasonable valuation for the business, and documenting that in both the CAP table and the logbook, is absolutely central to getting any funding, we want to discuss a few principals one should consider when setting the pricing for what to charge at the next round of funding:

1. *What was the price charged on your last round of funding?* Every investor will ask this question and, if the price is double the last round, they are going to ask for justification. If the market has collapsed, there is a chance the overall market value has declined so an increase in value will need to be justified. Under that circumstance, all the company's progress may just go to keeping them (and the value) at a level playing field vs. allowing for a reasonable growth in their valuation.

   It is possible for a company to go through a 'down round' if they find themselves stuck in raising capital and an investor with cash to invest comes in and negotiates for a lower valuation, with more equity for the same amount of money you may have paid in your round. Usually current investors are protected by so-called anti-dilution provisions. They are protected, so who takes the hit? The founders, that's who.

2. *How long has it been since they raised that last round?* If the last round was just six months ago, they'd better have accomplished some startling things to justify anything more than a modest increase in your valuation. We've seen entrepreneurs try and raise their valuations 3-4 times in just a couple of months with virtually no progress in the business. Any experienced investor will not believe nor accept such magic.

3. *What are investors paying for similar companies in that industry and at their stage of development?* If this can be documented, it's always the best advice. And if there has been a regulatory change that could affect the growth of their target market, that may have an outside impact on the overall valuation of the company. Even though we have a fancy spreadsheet to calculate valuation, you may simply choose to forget about all the "formula" methods for computing valuation. Most investors don't use them after all. And it really comes down two things…. What is the price people are willing to pay for THAT Company, THAT leadership team, doing what THEY are doing at THAT moment in time in the market? In fact, the method that most investors fall back on is the "comparable value" method.

   Think of it as being exactly like the method used to value you home. A real estate agent looks at all the "comps" in your neighborhood for houses "like yours" that sold recently. This forms the basis for determining what price to place on your home. Be sure and do your homework here! Sophisticated investors will not be fooled by "hyped" comps either, particularly in this day and age of "unicorn" companies with inflated valuations. Don't let that trend inflate the value of the company you are interested in just because they are in the similar space as the 'unicorn' company. Where can I see what earlier companies are getting? Here are a few resources:

   a. Gust (http://gust.com)
   b. CrunchBase (http://crunchbase.com)
   c. AngelList (http://angel.co)
   d. Andreessen Horowitz (http://a16z.com) Spend some serious time here learning.

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Factors for the CAP Table Valuation

How should an entrepreneur value an early stage business for CAP table entry? Numerous factors influence how investors view what a fair pre-money valuation should be for your startup. Here's a list of the most common factors:

- **Founders and Team**. How experienced is the founding team? Have they worked on a startup before or is this their first go? The most successful businesses have a salesperson, a tech person, and an operations person. Everyone brings their own expertise to the table.
- **Market Size**. How big is the market that the startup is going after? Do a few large players dominate the market or is it large enough, with no clear leader, to support several players?
- **Revenue Projections**. What are the revenue projections over the next few years? Usually three to five years out is the furthest you should project. Is the amount of revenue reasonable in relationship to the market size estimates?
- **Technology or Market Solution**. Does the technology or product or service offer a significant advantage to potential customers or is it merely a "nice to have"? Is it unique or revolutionary? How much of the market could use it? How much of the market might use it?
- **Competition**. What is the competition like in the startup's space? Does the startup have a significant way to differentiate itself from the competition?
- **Intellectual Property**. Does the startup have significant IP (i.e., patents, trademarks, service marks, copyrights, or other trade secrets) or some other strong competitive advantage? Is there a "moat"?
- **Customer Traction**. Do you have paying customers or a high rate of user signup? What is the acquisition cost of a new customer *compared to the lifetime value* of that customer?
- **Exit Potential**. Is it reasonable to believe that the startup can achieve enough success to attract the attention of a potential acquirer? Have possible acquirers been identified?
- **Advisors**. Is there an experienced advisory team that can help the founder enter their primary market segments? Is there a formal board of directors to assist the founders? What are the skills that the advisors and board of directors bring that augment the founder team?

We have saved this for the end. It just might be easier and faster to *ask the investor to put a value* on the business that they are comfortable with. An experienced investor will usually be able to quickly assign a value even though you might not agree with it.

We hope that you now have a better appreciation of the importance and format of the CAP table and how valuations are created by the founders. The CAP table is an extremely important document that can either help or severely hinder a company's ability to raise money because it is indicative of the discipline and organization the company has gone through prior to your meeting them and considering them for investment.

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SAMPLE CAP TABLE

Section #1		Section #2				Section #3			Section #4			% of Co.
List of Shareholders		Founder's Round (9/1/02)[a] Founder's Common				Employee Option Pool Common Shares			1[st] Private Funding Round[b] Preferred Stock			
Name	Role	Date	Capital	Shares #	Shares %	Date	Shares #	Shares %	Date	CAPital	Shares	
1. John Founder	CEO	9/10/02	$5000	5,000,000	50%							36.0%
2. Bob Co-Founder	VP	9/10/02	$5000	5,000,000	50%							36.0%
3. Option Pool						11/1/02	2,500,000	20%				
4. Susan Anthony[c]	Director					3/15/03	10,000		3/15/03	$5,000	33,333	0.3%
5. George Venture	Director					4/1/03	10,000		4/1/03	$5,000	33,333	0.3%
6. Angel #1									4/2/03	$100,000	666,667	5.0%
7. Angel #2									4/5/03	$40,000	266,667	1.9%
8. Angel #3									4/15/03	$250,000	1,666,667	11.9%
9. Angel #4									5/12/03	$150,000	1,000,000	7.1%
10. Angel #5[d]									6/1/03	$50,000	333,333	2.4%
		TOTAL	$10,000	10,000,000	100%				TOTAL	$600,000	4,000,000	28.6%
			Unit Price =	$0.001		OP Dist's=	20,000		Unit Price =	$0.15		
			Pre-$ Value =	$0.00		OP Bal=	2,430,000		Pre-$ Value[e] =	$1,500,000		
			Post-$ Value =	$250,000					Post-$ Value =	$2,100,000		
			New Unit Price =	$0.025								
			New Share Total =	10,000,000	100%		12,500,000	100%			14,000,000	100%

[a] Date company was founded.

[b] This round was opened officially on 3/15/03 and was done via a PPM for $750,000. The round was closed at $600,000 on 6/1/03.

[c] Directors were awarded 10,000 shares for agreeing to serve and 5,000 shares annually. They were also required to make a modest investment.

[d] Management decided to close the 3/15/03 PPM prior to completing the targeted $750,000 because it was anticipated that, in the next 90-120 days certain significant milestones would be achieved that should justify a 50% increase in valuation. Therefore, it was decided to minimize shareholder dilution and issue another PPM at that time.

[e] Pre-money valuation was determined based on (a) comps of similar companies in our space as of 3/03 and (b) because the company received approval on its patent, recruited two significant directors and closed a major customer account.