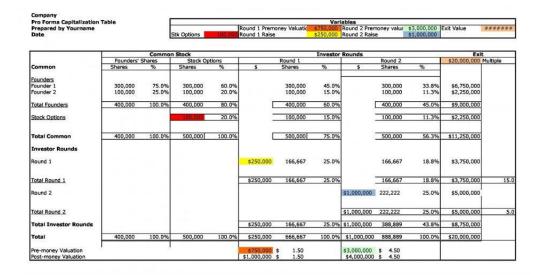
## Don't Pay Too Much! Use Cap Tables to Ensure Deals Are Right For You

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Angel investing is risky. This is a mantra my readers have heard me repeat time and again. I'm game for doing everything possible to mitigate risks and increase success. It's also why, although I don't have a PhD in finance, I've made it a priority to understand the fundamentals of capitalization tables, known as "cap tables."

A pro-forma capitalization table is a spreadsheet that reflects the capitalization structure of a company today as well as immediately following a potential investment (i.e. on a "pro forma" basis). It shows the percentage ownership of investors and founders, fully diluted, after a funding round, and differentiates preferred and common shareholders, among other things. Cap tables are typically attached as an exhibit to a financing term sheet. An investor can also use a pro forma cap table to help assess the effect on their ownership of dilution from future rounds. Finally, a pro forma cap table can be used to estimate the likely allocation of returns if the company is sold and quantify potential returns based on estimated proceeds in various exit scenarios.

The more time I spend with these spreadsheets, the cooler they become. Here's why: This tool captures the key variables affecting my investment, and when different possibilities are calculated it helps me quantify possible outcome scenarios. This provides insights that help me negotiate my investments more effectively. Put another way, the cap table can help you make decisions that ensure you get in at the right price, and preserve your investment for the best possible exit.

So how does a non-finance person start to understand cap tables? This week I got some lessons from two experts: <u>Kevin Learned</u>, a Board member of the <u>Angel Capital Association</u> and <u>Trevor J. Chaplick</u>, an attorney and shareholder in the Private Equity/M&A and Corporate and Securities practices of <u>Greenberg Traurig</u>, <u>LLP</u>.

Kevin did a 20-minute <u>introductory presentation to capital tables</u> for investors and entrepreneurs to learn from. He also provided a <u>downloadable basic cap table model</u>. Trevor is leading an ACA webinar in September on <u>The Basics of Cap Tables</u>, which will build on Kevin's introduction, getting into the real world twists and turns of angel deals, subsequent institutional financings and exit scenarios. Trevor's most important tip? "Don't think of a cap table as just a financial document. Use it as a discipline to force a discussion and negotiation of the variables that will have a direct bearing on the success or failure of your investment. Use it as a key tool to quantify both how you get in and how you may exit an investment." Great advice.

Angels should prepare a cap table like Kevin's model at the beginning of due diligence to understand and negotiate the impact of stock options for founders and employees, to negotiate the pre-money valuation of the company, to assess the impact of dilution from future funding rounds, and to estimate possible exit multiples on your investment.

A basic cap table model like this one includes these main components:

- Left column: A list of all stock holders, with the column growing as the company gains new investors
- Across the top: Details of the initial founders' shares, then stock options, each investor round, the effect of subsequent dilution from any ratchet adjustments, and a potential positive exit.
- The cap table also shows: the pre-money valuation and raise amount for each round, leading to a post-money valuation that also computes the number of shares and price per share for investors.

More complicated cap tables would also include terms such as liquidation preferences (identifying which investors get paid first) and participation rights, as well as deal costs for an exit.

The variables in the basic cap table are the shares allocated for stock options (known as the "option pool"), pre-money valuation, and the amount of the raise. These variables will lead to the calculation of the price per share. Ultimately investors can use the cap table to assess the effect of future rounds and the impact on their investment from various estimated exit values. By using these same variables, angels can use a pro-forma cap table to quantify the impact on their percentage ownership and how diluted they would be in future rounds. With a basic understanding of the typical pro-forma cap table components, you can use the information to ensure you're negotiating win-win terms by having the right discussions with startups. For example, first and foremost, you want to determine if you paying too high a valuation in a round given the risk profile of the company and the potential return at exit.

Here are some other questions to consider and discuss with your fellow investors and attorney, as you run the math to understand potential impacts:

- What is the impact of future rounds on your investment and is the related dilution in line with customary conventions for the industry/business type? (This means it is important to review the cap table analysis for all financing rounds even if you do not plan to participate in them.)
- Has the option pool for founders been negotiated in advance and factored into the price per share so that investors are not diluted by future option grants? Is the pool sufficient to attract employees for the time period the company projects for the use of your investment?

- How could company performance issues dilute your ownership in the company? Typically, if a company performs poorly or if there are down rounds, dilution is higher.
- What will be the impact on returns from future dilution? Typically dilution from future financings has a much greater impact on returns than other variables (such as transactional costs at exit).

Of course there are many more questions that will come up as you start working through possible scenarios. Also, don't forget to factor in the impact of other deal terms. For example, understanding the liquidation preference impact on your returns is important because typically angels are more junior in the "preference stack". Likewise, keep an eye on participation rights and any accrued dividends which can dilute your investment over time as such dividends accrue.

Is there a lot to learn? You bet. But when you think of cap tables as a discipline that starts the deal conversation so that you can negotiate more wisely, it gets a little easier. Don't let the lack of a finance background or confusing legal terms slow you down. Learn all you can by talking to others in the know and tap into helpful resources like the ACA <u>knowledge center</u>. I encourage you to attend the free <u>ACA</u> <u>webinar</u> on September 14.