Bio Professional Development Program

San Diego
June 1-2, 2024

Become a Biotech or MedTech Entrepreneur

Session 19:
Structuring and Financing Your Venture

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Formation -- Why? / What?

Governance -- Decision-making / Board Dynamics

Financing -- Process / Cap Table / Exit*

*APPENDIX – more detail regarding Conversion of Notes and SAFEs

In the Beginning . . .why?

Formation

Good:

- **SBIR/STTR Funding**
- **IP out-licensing / assignment**
- **External partnership opportunity**
- **Anything involving taking money from other people**

Less Good:

"My brother did it, and it looked easy."

The Value Proposition

how good is the story

Entity structure, equity distribution, employee compensation are understandable, appropriate and consistent with typical arrangements

Risks associated with technology development and product acceptance have been identified, and strategies for minimizing them are sensible

Estimates of market size, timeline to market entry; pace of acceptance (and scale of reimbursement) are credible

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The Value Proposition – what matters

Novel

Not Novel*

***but an impediment to financing if this is**

In the Beginning . . . ~~why?~~ . . . what?

Formation

Types of Entities

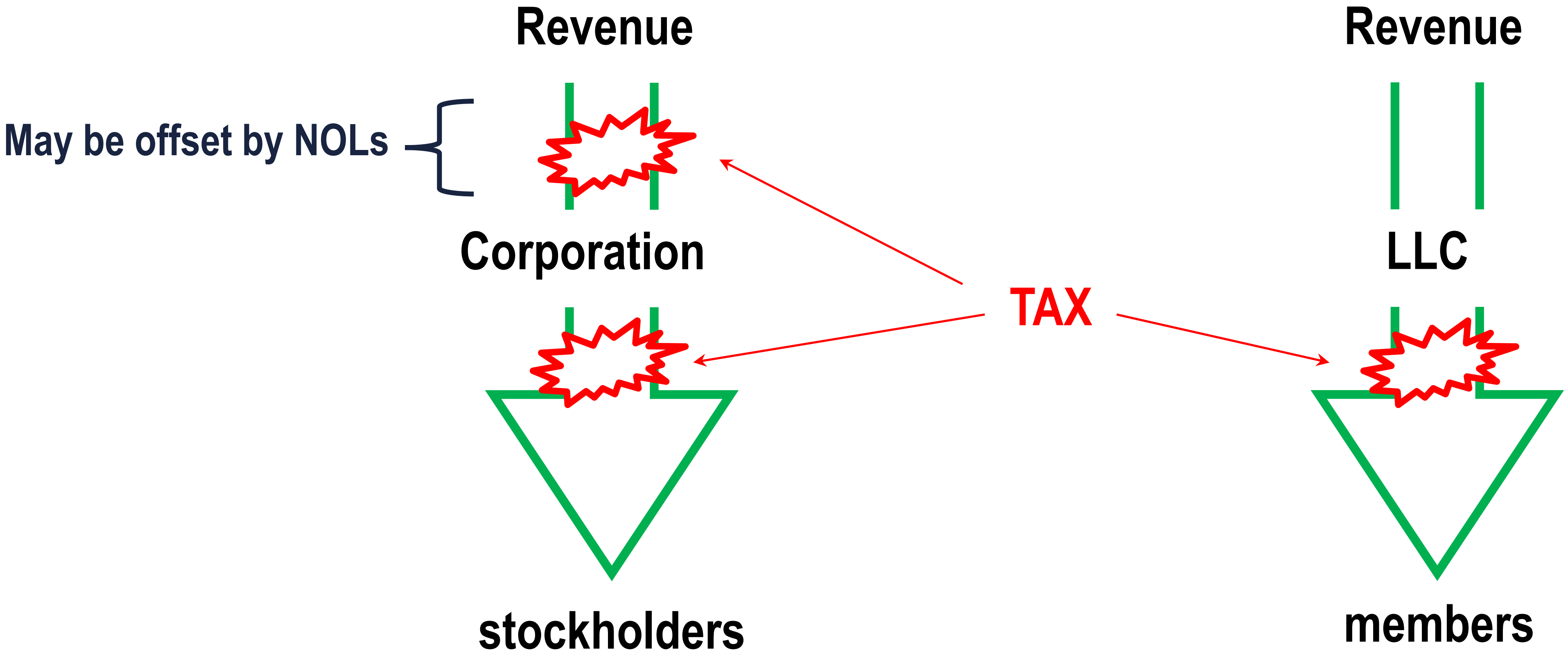
"C" Corporation	**the default choice; well-understood capital & operational structure; M&A/IPO advantages**
Limited Liability Company (LLC)	**tax advantages (esp. for partial exits); simplified operational structure (ex. members as employees)**
"B" Corporation	**for-profit, but <u>stakeholder</u> – not <u>stockholder</u> – oriented; mission driven**

Also, where to incorporate / organize?

Words Meaning (Essentially) the Same Things

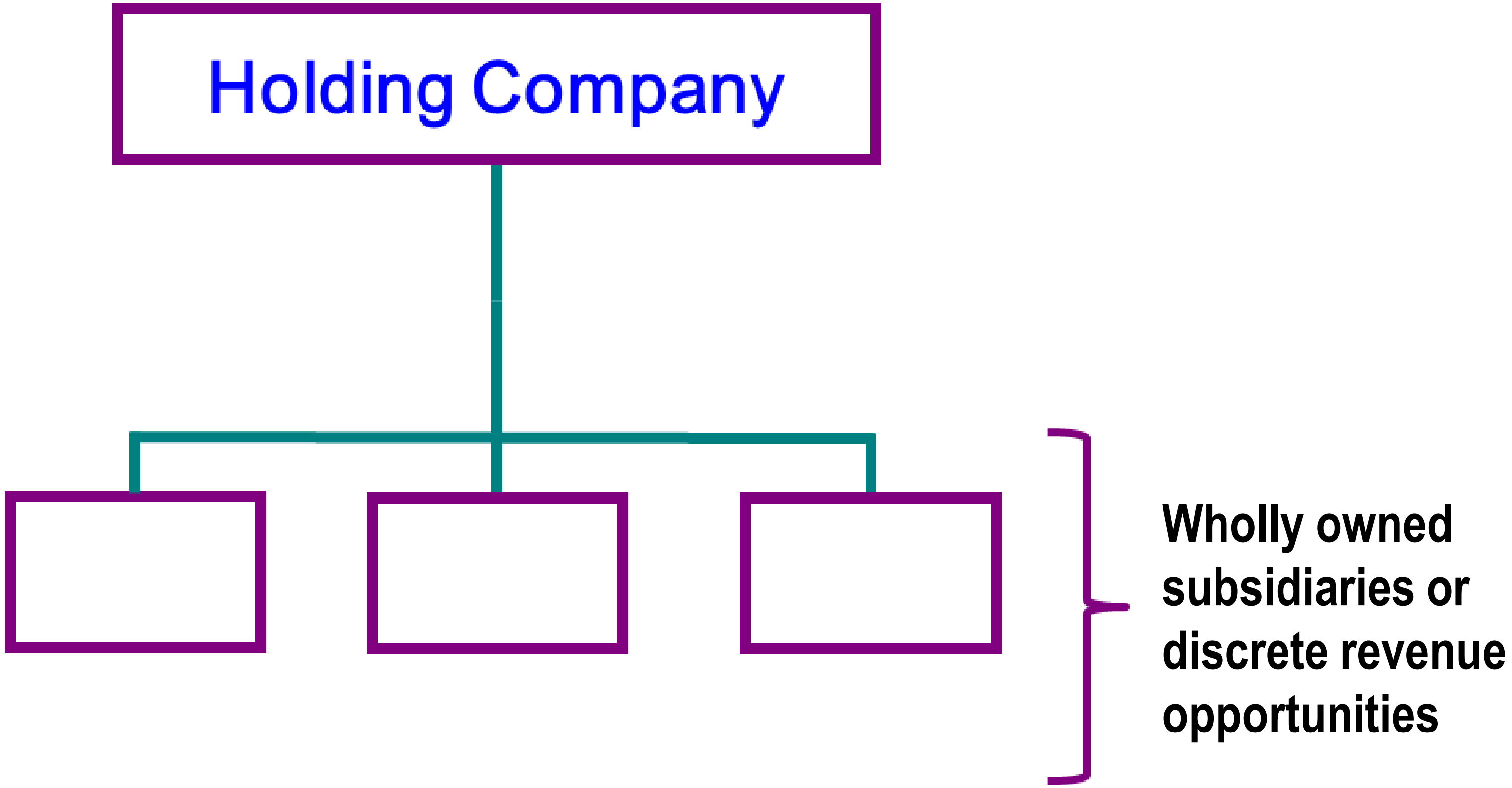
Corporation	LLC
Board of Directors	Board of Managers
Stockholders	Members
Capital stock	Membership interests (“Units”)
Stock options	Profits interest

Taxation Models



but, cap. gains tax “forgiveness” for “C” corp. stock sale (IRC§1202)

LLC Model for Discrete IP/Product Assets



also, consider IRS perspective on employees as members

Angel Capital Association – Annual Angel Funders Reports
(www.angelcapitalassociation.org)

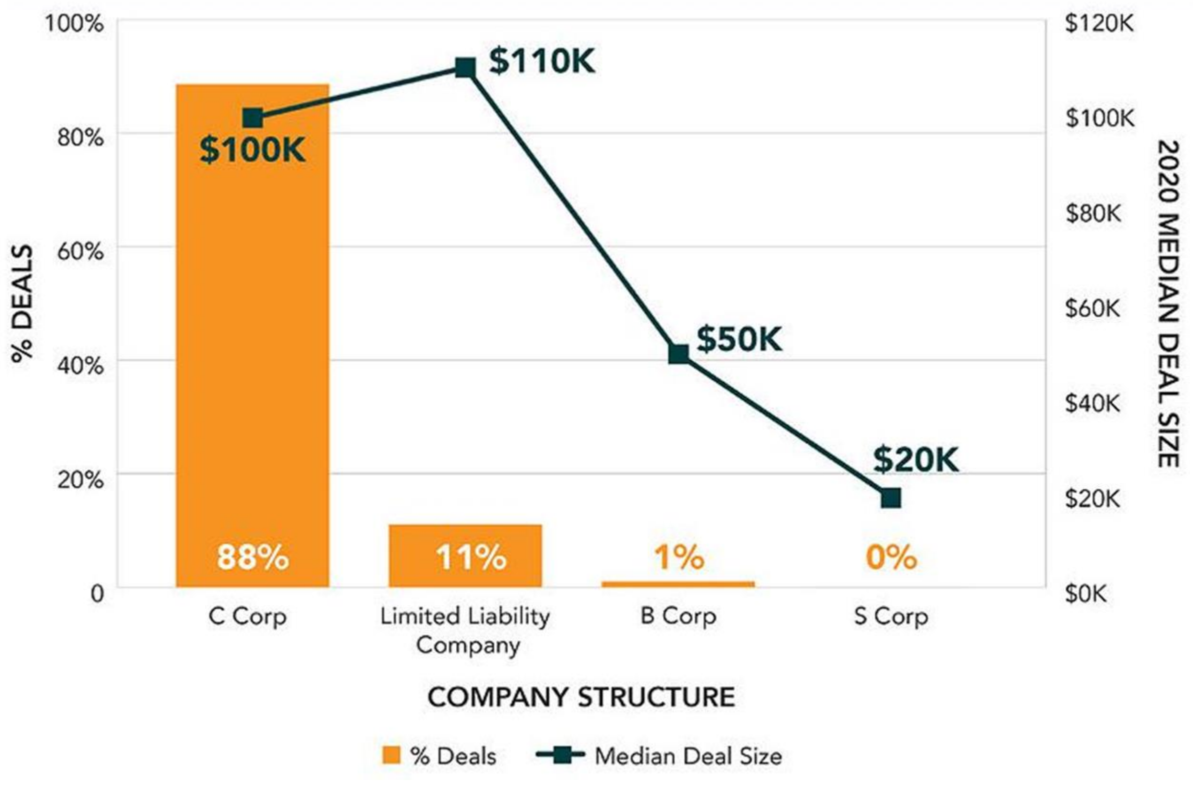


Figure 16 – C Corp Dominate Company Structures

2021 Report

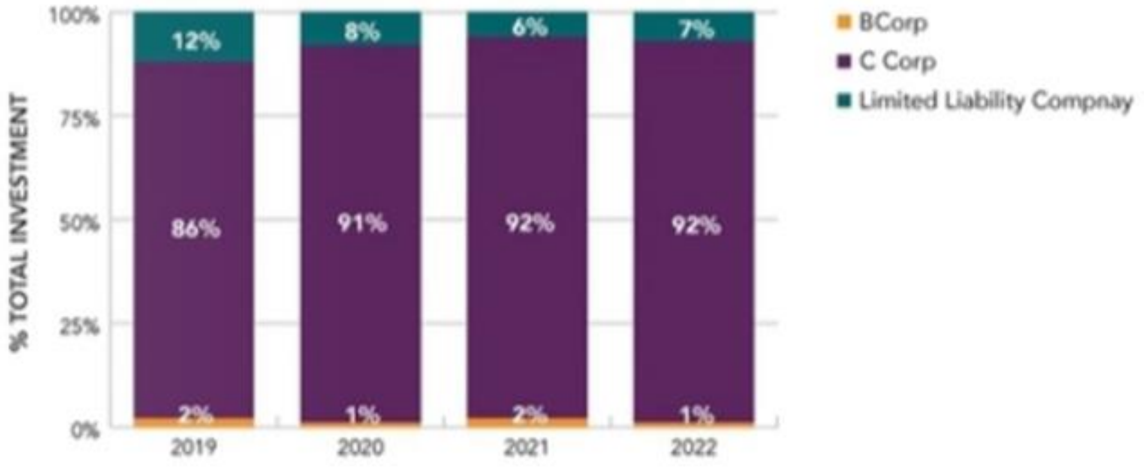


Figure 24 – Legal Structure as a Percent of Overall Investment

2023 Report

In the Beginning . . .

Governance

Branches of Governance	Role / Rights
Board of Directors	Fiduciary duty to oversee company on behalf of stockholders Comprised of: investors, CEO, outsiders, founders(?)
Management	Responsible for: establishing and implementing strategic direction (subject to Board approval); and day-to-day operations
Stockholders	Elect Directors Vote on fundamental changes (stock rights, financing, exit) Not involved in day-day operations (ex. informally)

Board Composition	Pros/Cons
Founders	P: commitment; loyalty C: inexperience with financing/commercialization process
Investors	P: commitment (to a point); source of further funding C: inexperience with commercialization process; 2 masters?
Industry Experts	P: educators to other board members (and management team!); relationships with prospective strategic partners C: misaligned with current technology/market (fighting the last war)
Influencers	P: early visibility for the company C: expensive; commitment issues

Duties of Directors	How Satisfied*
Duty of Care	Care requires informed, deliberative decision-making based on all material information reasonably available.
Duty of Loyalty	Loyalty requires acting (including deciding not to act) on a disinterested and independent basis, in good faith, with an honest belief that the action is in the best interests of the company and its stockholders.

*includes obligation to be informed about the company and to disclose conflicts

Becoming operational . . .

Financing

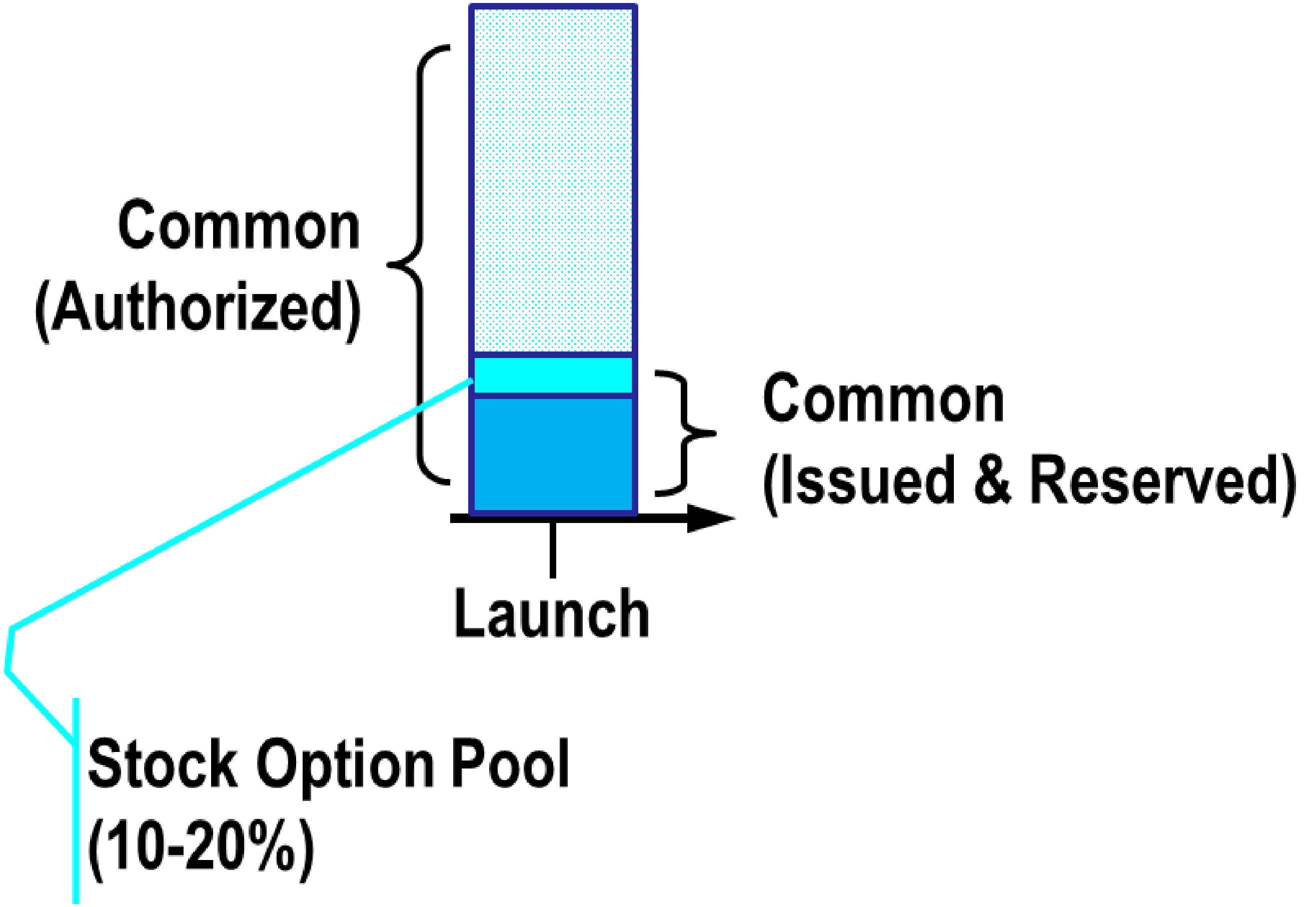
process
key elements/terms

Capitalization

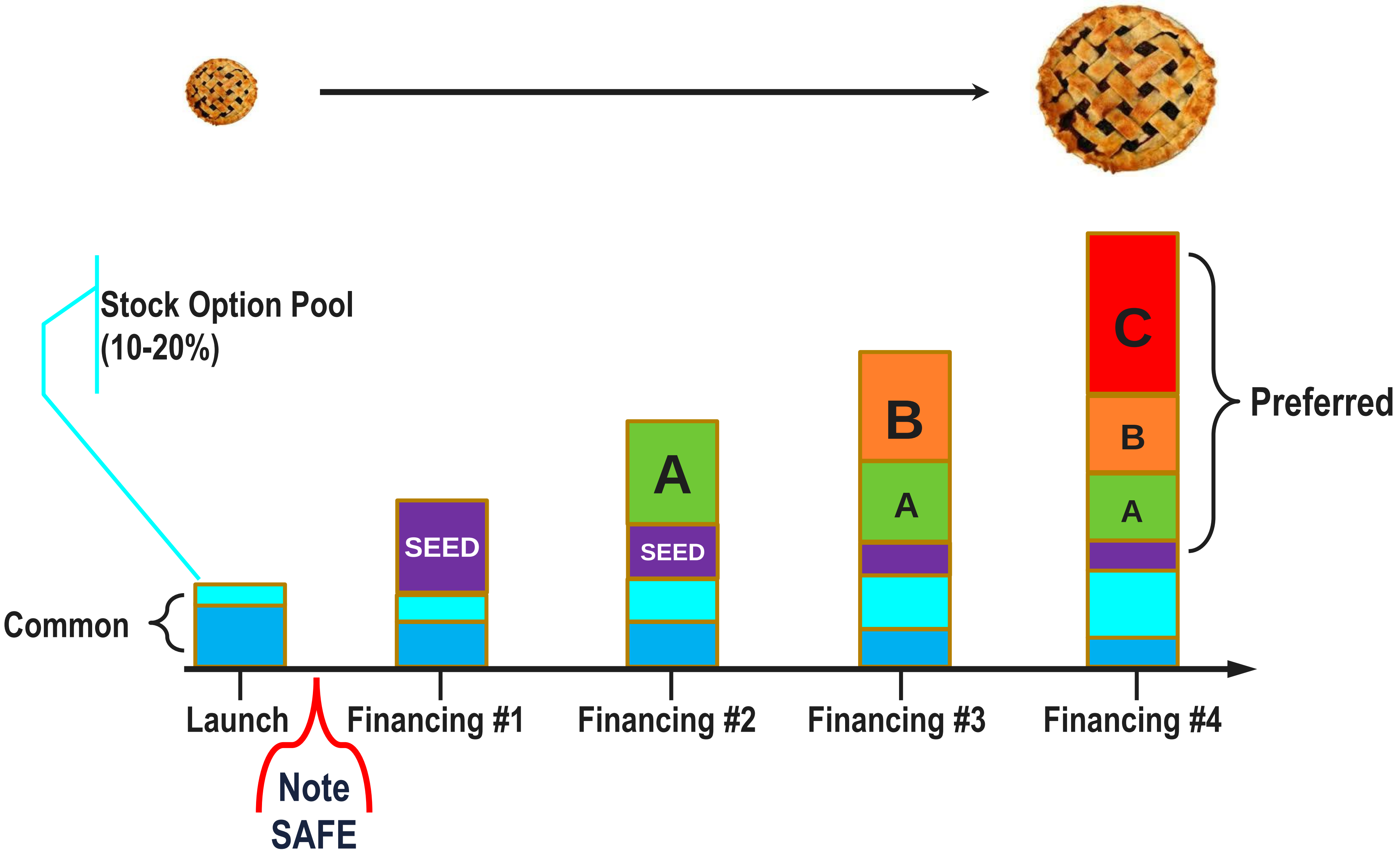
Capital Stock	What's Included
Authorized	**Everything** (max. number of shares of any kind the company can issue or reserve)
Issued	**Common** (initially – to founders) and **Preferred** (to investors)
Reserved	Stock Option Pool, Warrants

"Fully Diluted" – relative equity interest based on sum of all issued and reserved shares (all as converted to common)

Financing (Capitalization)



Financing (Building the Cap Table)



Simple Cap Table

Life Sciences, Inc.				
Pro Forma Capitalization Summary as of [date][1]				
Issued Shares[1]	**Common Shares**	**Preferred Shares[1,2]**	**% interest (voting)**	**% interest (fully diluted)**
Common Holders	429,917		29.38%	23.67%
Series A Holders		280,734	19.18%	15.46%
Series B Holders		483,118	33.01%	26.60%
Series C Holders[3]		269,605	18.42%	14.85%
TOTAL Issued	**429,917**	**1,033,457**	**100.00%**	**80.58%**
Reserved Shares				
Equity Incentive Plans[4]	308,800			17.00%
Series A Warrants		43,900		2.42%
TOTAL Reserved	**308,800**	**43,900**		**19.42%**
TOTAL Issued	**429,917**	**1,033,457**		**80.58%**
TOTAL Issued and Reserved	**738,717**	**1,077,357**		**100.00%**

Notes:

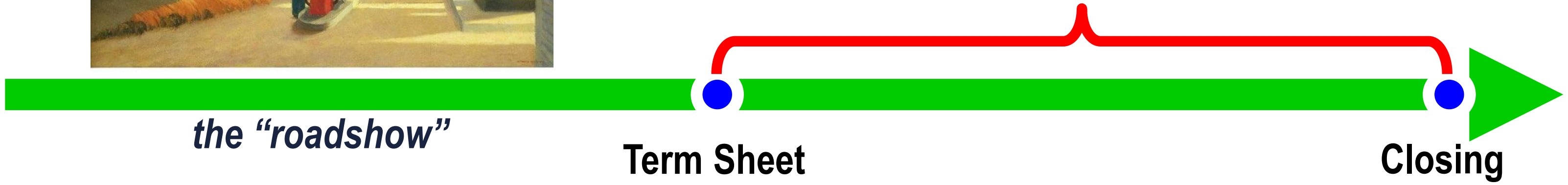
[1]Does not reflect conversion of outstanding convertible notes having aggregate principal of $X and accrued interest of $Y

[2]Presented on an as-converted-to-common basis (current conversion ratio of all classes of Preferred to Common is 1:1)

[3]Represents shares issued upon conversion of outstanding convertible promissory notes as of December 23, 2014

[4]Includes all shares of Common Stock subject to outstanding grants and available for future grants under the Company's 2010 and 2020 Equity Incentive Plans

Financing (Process & Documentation)

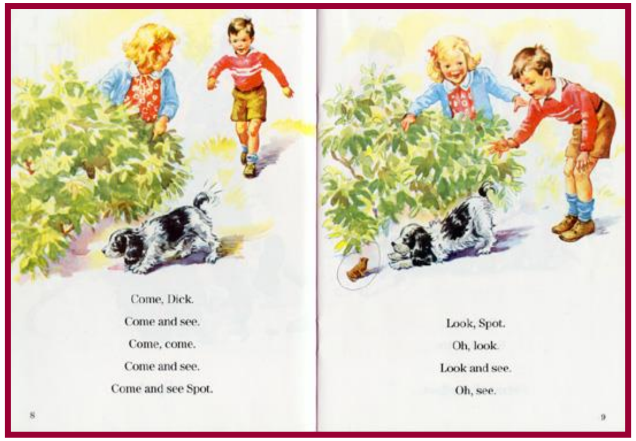


Document	Purpose
Term Sheet	*Preliminary terms of investment: pre-investment valuation; class & rights of stock to be sold; issue price; board representation; closing conditions (due diligence; aggregate investment commitment)*
Purchase Agreement, etc.	*Definitive investment terms; ancillary agreements; company reps & warranties; pre- & post-closing conditions*

Financing (what matters)

What	Why
Valuation	*Establishes relative equity interest acquired by new investors (may trigger anti-dilution rights of older investors – a “down round”))*
Capitalization	*Establishes relative voting rights and liquidation preferences of all stockholders*

Financing (Key Securities Laws)



Keep it simple
Keep it accurate

<u>The Rules</u>:

SEC (“1933 Act”) – exemption from registration
but consider state “Blue Sky” requirements – prior registration?

Investor Disclosures – material facts; no material omissions

“Accredited” Investors – having ability to withstand loss and evaluate risk

private-private vs. public-private offerings (Rule 506(b) vs. 506(c)*)
***(*e.g., www.verifyinvestor.com*)**

The Early Life of the Company – Financing (Overview)

Structure	Valuation	Investor Rights	Founder Commitment	Documentation
Debt (conv. note)*	N/A**	▪ Information rights? ▪ Cap on add'l debt? ▪ Conversion terms	▪ Employment ▪ Restrictive covenants ▪ Equity vesting	▪ Purchase Agmt ▪ Note ▪ Warrant?
SAFE***	N/A**	▪ Information rights? ▪ Conversion terms		▪ Purchase Agmt
Equity ("seed" or Series A)	Negotiated	▪ Information rights ▪ Board seat? ▪ Future Purchase right ▪ Voting rights		▪ Purchase Agmt ▪ ROFR Agmt ▪ Invstr Rghts Agmt ▪ Voting Agmt

*beware tax issues for LLC members

**but may set "Enterprise Value" for conversion

***"Simple Agreement for Future Equity"

Financing (Documentation – equity round)

Document*	Purpose
Stockholders Agreement	Rights/Obligations applicable to all Stockholders *(i.e., restrictions on transfer of shares; designation of board nominees & election of directors, etc.)*
Investor Rights Agreement*	**Rights/Obligations Negotiated Through Investment** ***(i.e., preemptive purchase rights, protective provisions, registration rights, etc.)***
Right of First Refusal & Co-Sale Agreement*	**allow Company and then stockholders to purchase selling stockholders' shares; require stockholders to sell shares along with selling stockholders**
Voting Agreement*	**require stockholders to vote on certain matters (esp. election of directors, but can require votes on other matters)**

***see NVCA model Series A transaction documents (www.nvca.org)**

Financing (Key Investment Terms – Preferred Stock)

Term	Function	Purpose
Liquidation Preference	Return of initial investment (+ dividends) ahead of general distribution to stockholders	Downside protection (if just 1X) Upside benefit (if > 1X)
Anti-Dilution	Downward adjustment of initial issue price if future round priced lower	Downside protection against over-valuation of the company for the initial investment
Voting Rights	Board representation Protective provisions	Ability to influence (maybe control) future key decisions about the business & exit

Financing (Preferred Stock – liquidation preference)

	Full Participating	Non-Participating	Participation Cap
Payout Formula	Liquidation Preference* payout + share remainder pro rata with Common	Greater of Liquidation Preference* <u>OR</u> pro rata distribution as Common holder	Liquidation Preference* payout + share remainder pro rata with Common up to ?X original purchase price
Value to Preferred	↓Exit protection with ↑Exit benefit	↓Exit protection with ↑Exit alignment with Common	Enhanced ↓Exit protection with reduced ↑Exit benefit
Impact on Common	reduces pro rata share of ↑Exit	Aligns pro rata outcome with Preferred (if ↑Exit)	Depends on cap multiple; Preferred holders indifferent to Exit above cap

*Liquidation Preference = original purchase price (or multiple) plus accrued interest

Becoming operational . . .

Financing

valuation

Financing ("Pre-Money" & "Post-Money")

"Pre-Money"	**$8,000,000**	**Represents value attributed to all shares sold or reserved (i.e., options) pre-financing**
Investment	**$1,000,000**	**Principal + interest of conv. notes**
	$3,000,000	**New money**
"Post-Money"	**$12,000,000**	**Sum of Pre-Money Valuation Amount + Investment**

Conversion Discount

How determined – negotiation; benchmarking
(less) net of outstanding debt

Financing (variables)

“Pre-Money”	***$8,000,000***
Note Conversion Discount	***30%***
Investor Requirements	***“Post Money” Cap? (say, $10M)***

Financing (Valuation – “founder friendly” method)

Founders & Option Pool	1,000,000	64.37%
Note Holders	178,571	11.49%
New Investors	375,000	24.14%
Total Issued & Reserved Shares	1,553,571	100%

Series A issue price	$8.00 ($8M Pre-Money ÷ (Founder & Option Pool Shares)
Eff. “Pre-Money” Valuation	$8,000,000
Eff. “Post-Money Valuation	≈ $12.43 million (Total Shares × Series A issue price)

Financing (Valuation – “investor friendly” method)

Founders & Option Pool	1,000,000	55.71%
Note Holders	256,407	14.29%
New Investors	538,455	30.00%
Total Issued & Reserved Shares	1,794,862	100%

Series A issue price	$5.5715 (to meet investor-req. $10M post-money val.)
Eff. “Pre-Money” Valuation	$5,571,500
Eff. “Post-Money Valuation	≈ $10 million (Total Shares × Series A issue price)

Financing (Valuation – "dollars invested" compromise method)

Founders & Option Pool	1,000,000	63.1%
Note Holders	188,677	11.9%
New Investors	396,223	25%
Total Issued & Reserved Shares	1,584,900	100%

Reflects new investment as % of post-money

Series A issue price	$7.5715 (to reflect pre-money + aggregate investment)
Eff. "Pre-Money" Valuation	$7,571,500
Eff. "Post-Money Valuation	≈ $12 million (Total Shares × Series A issue price)

Return on investment . . .

Financing

outcomes

EXIT (payout "waterfall")

Liquidation Preference Distribution

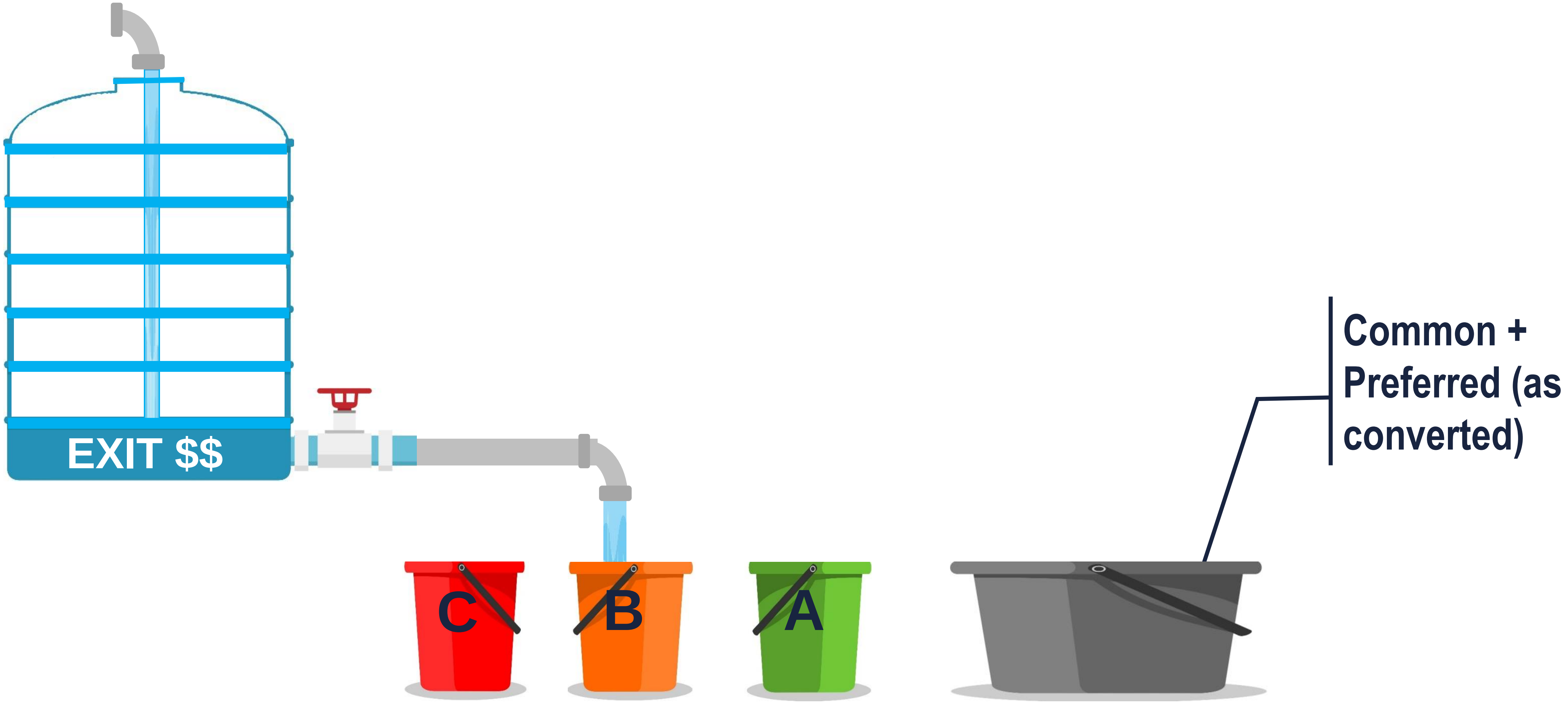
Liquidation Waterfall -- $20M Exit, Participating Preferred

Exit Proceeds (amount remaining after payment of outstanding debt, etc.)		**$20,000,000**	**Remaining After Payout**
Liquidation Preference Payouts	**Series C**	**$15,000,000**	**$5,000,000**
	Series B	**$10,000,000**	**$0 (only ½ of Payout made)**
	Series A	**$5,000,000**	**$0**
Net Exit Proceeds (amount to be distributed to Common + Participating Preferred on pro rata basis)			**$0**

EXIT (payout “waterfall”)

Liquidation Preference Distribution

EXIT (payout “waterfall”)



Liquidation Preference Distribution

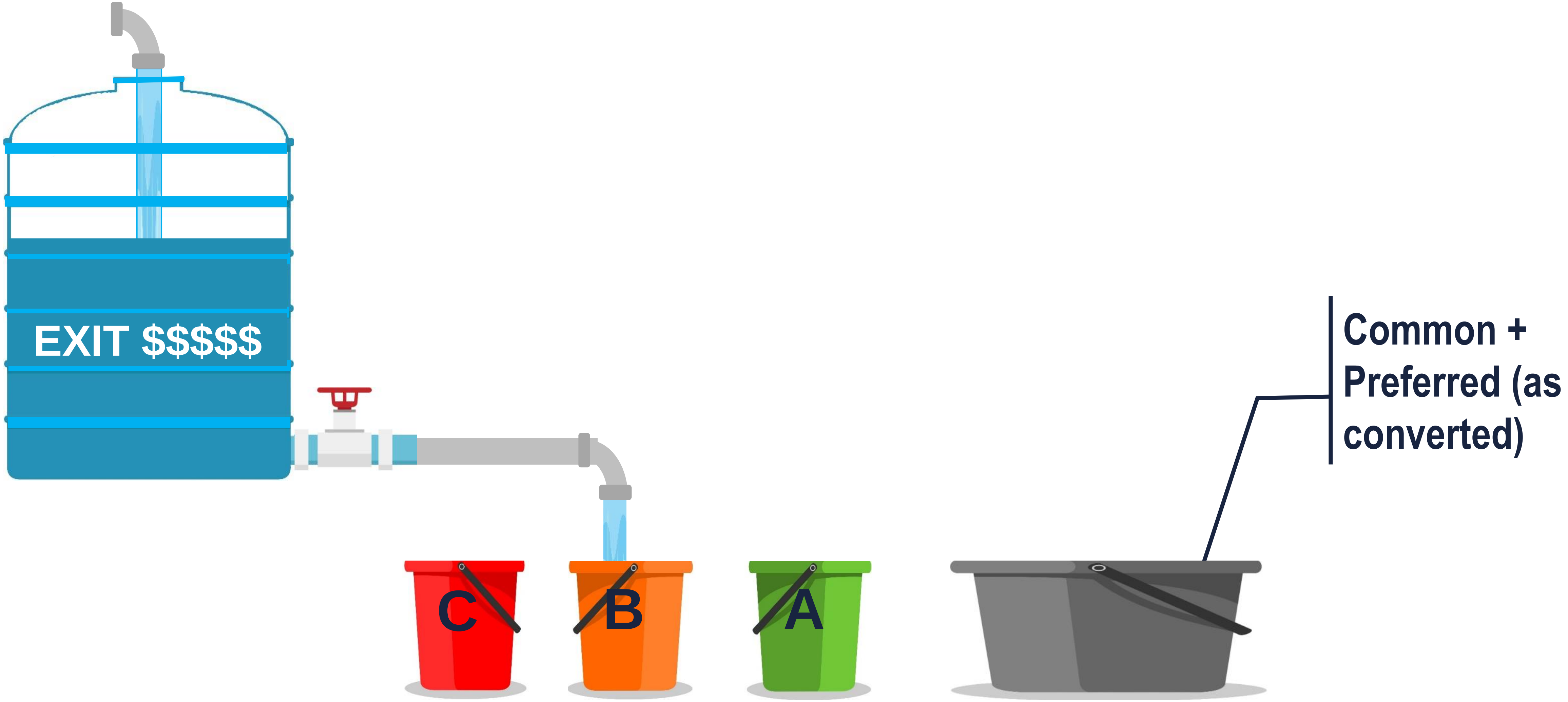
Liquidation Waterfall -- $120M Exit, Participating Preferred

Exit Proceeds (amount remaining after payment of outstanding debt, etc.)		**$120,000,000**	**Remaining After Payout**
Liquidation Preference Payouts	**Series C**	**$15,000,000**	**$105,000,000**
	Series B	**$10,000,000**	**$95,000,000**
	Series A	**$5,000,000**	**$90,000,000**
Net Exit Proceeds (amount to be distributed to Common + Participating Preferred on pro rata basis)			**$90,000,000**

EXIT (payout "waterfall")

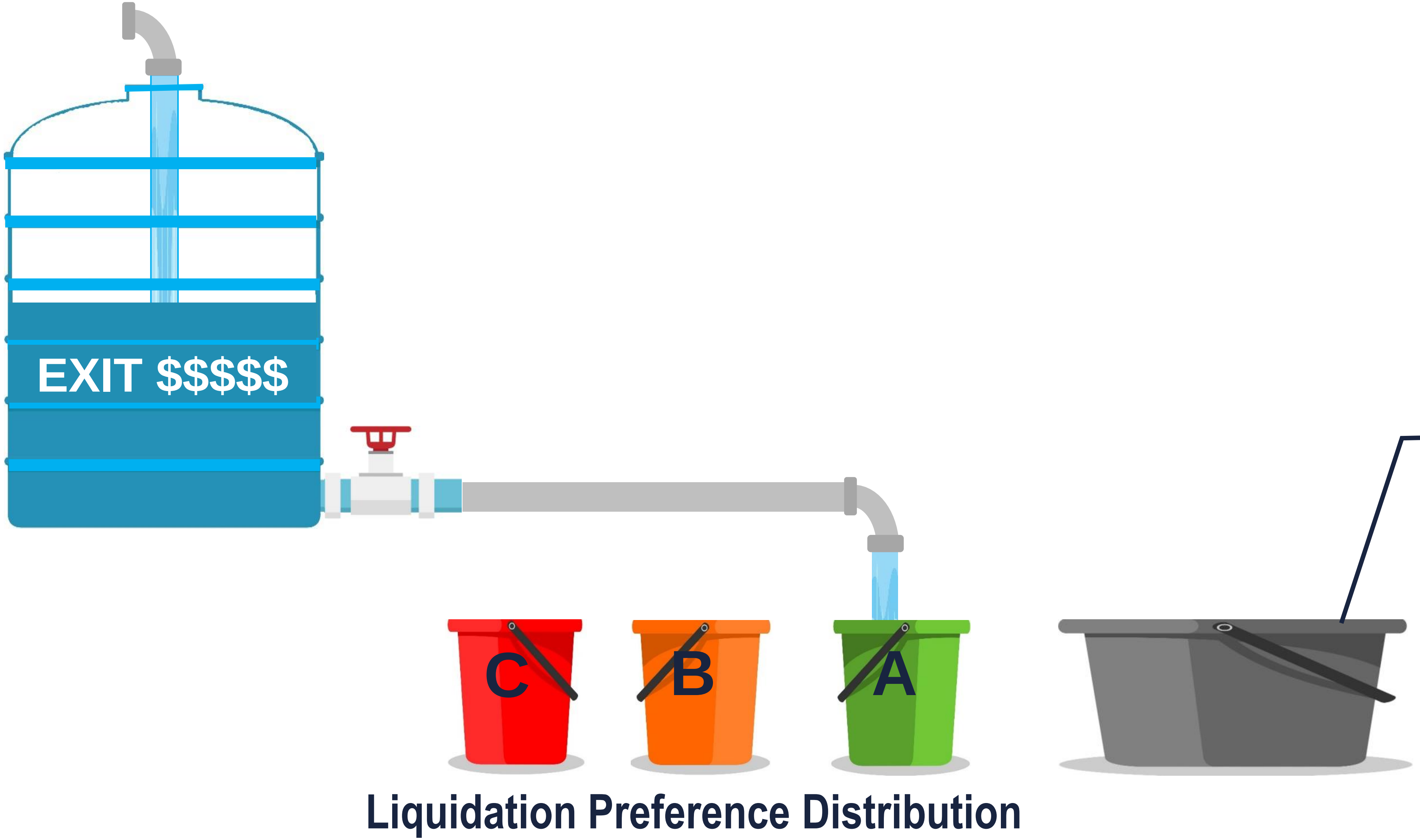
Liquidation Preference Distribution

EXIT (payout "waterfall")

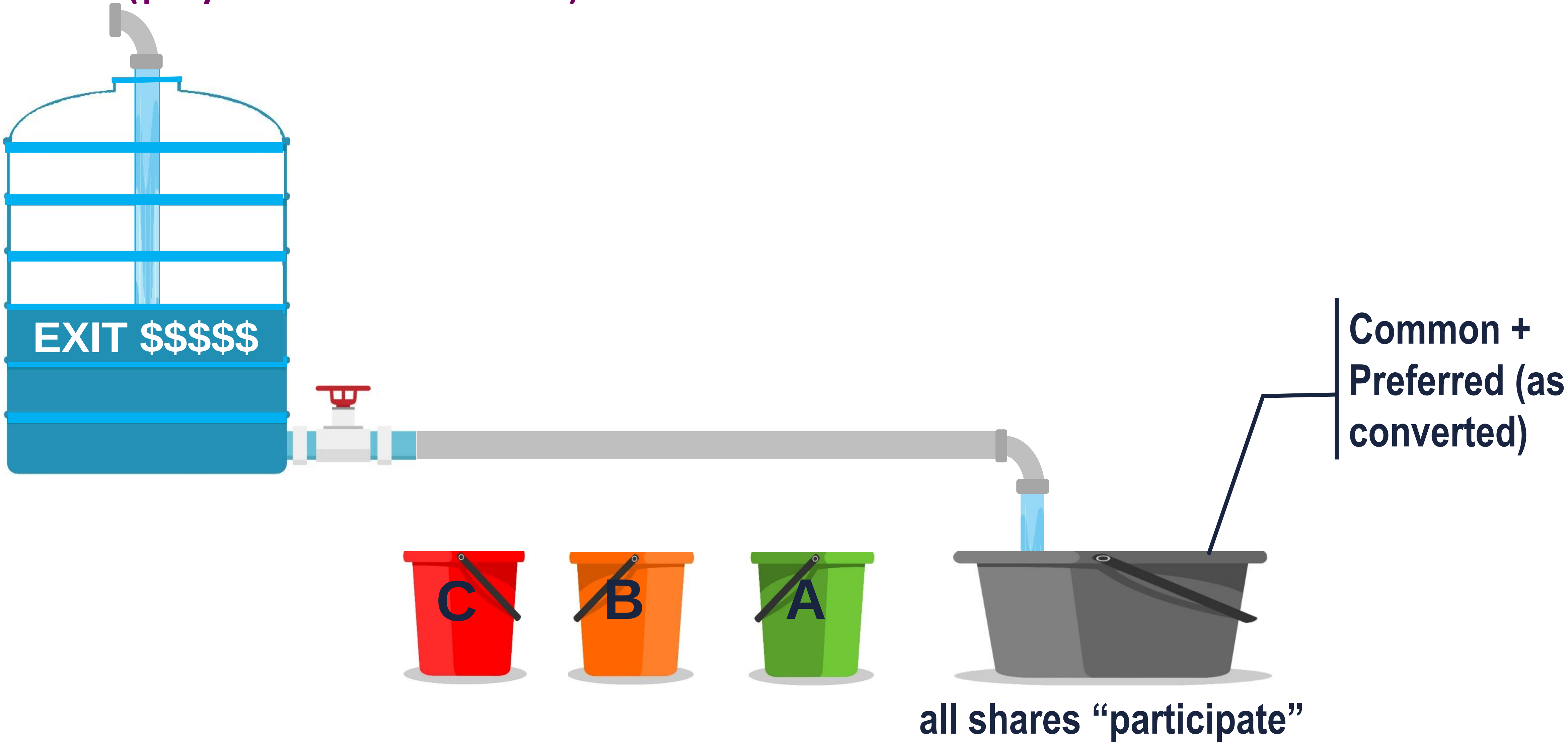


Liquidation Preference Distribution

EXIT (payout “waterfall”)

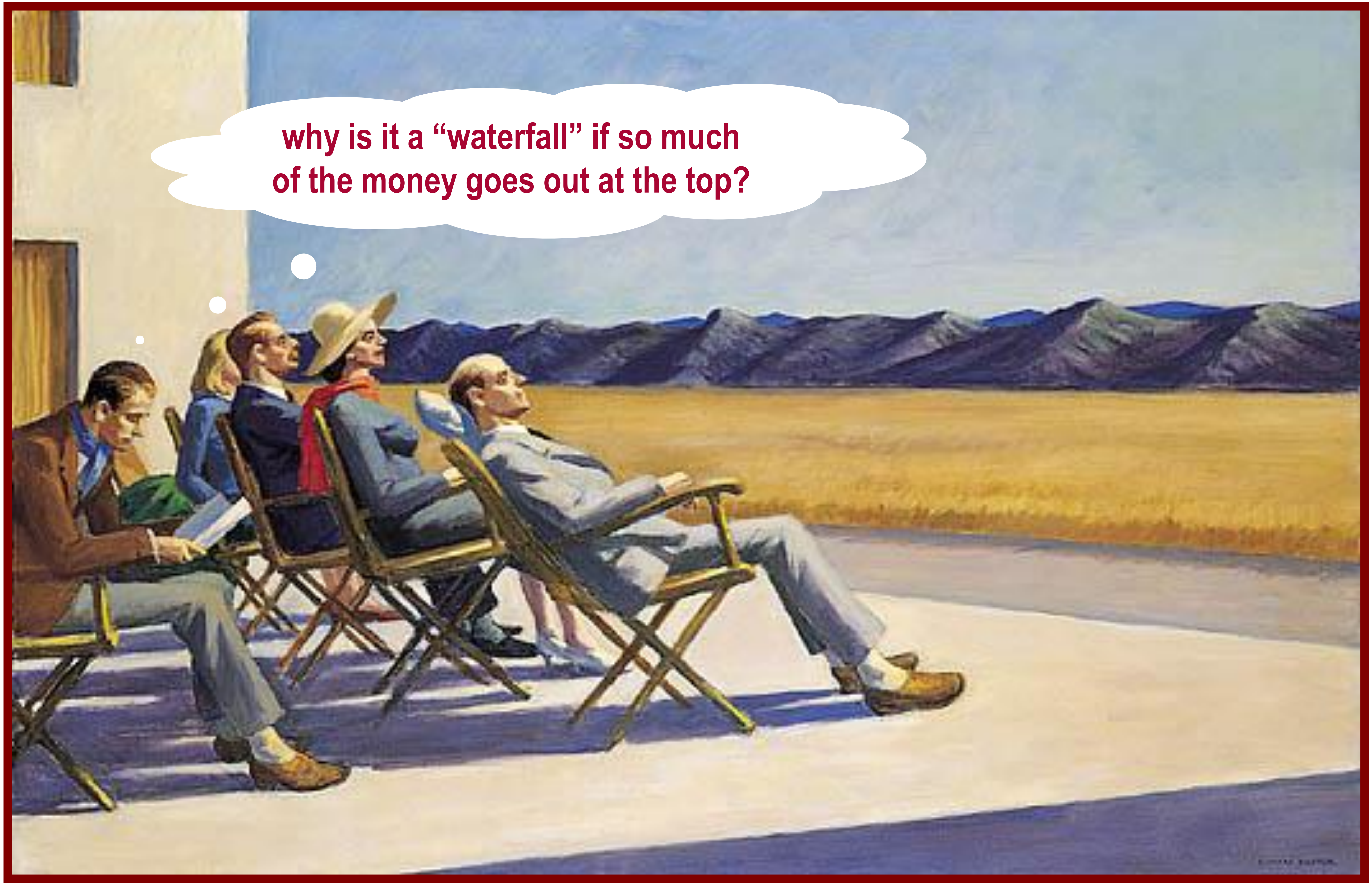


EXIT (payout “waterfall”)



Liquidation Waterfall -- $120M Exit, Participating Preferred

	% of Issued Shares (as converted to Common)	Liquidation Preference	Distribution of $90M Net Exit Proceeds	Total Distribution (~% of Exit)*	ROI
Series C	35%	$15,000,000	$31,500,000	$46,500,000 (38.75%)	3.1X
Series B	25%	$10,000,000	$22,500,000	$32,500,000 (27.09%)	3.25X
Series A	10%	$5,000,000	$9,000,000	$14,000,000 (11.66%)	2.8X
Common	30%	N/A	$27,000,000	$27,000,000 (22.5%)	??X


why is it a “waterfall” if so much
of the money goes out at the top?

Appendix

What are Convertible Securities?

Convertible securities are instruments issued by a company that convert into stock at a later date, contingent upon a trigger event, such as when the company does a priced equity round

Convertible Notes

Technically debt

- ✓ **Accrues interest,** typically between 4% and 8%
  - May be paid in cash periodically, at maturity or, most commonly, converted into equity along with the principal
- ✓ **Maturity date** is typically 6 to 24 months after signing
  - The note will only mature and become due in cash if the company doesn't complete an equity financing during the term
- ✓ **Can also include a security interest in the assets of the company**

SAFE
(Simple Agreement for Future Equity)

Developed to **facilitate simple, efficient investments by early-stage investors**

Technically a convertible security (neither equity nor debt)

X **No interest rate**

X **No maturity date**

- May be advantageous for company because removes the pressure of a "deadline" to complete an equity financing or risk needing to pay off the notes or negotiate an extension

Why Use Convertible Notes or SAFEs?

Allows a company to more efficiently raise funds before its first priced equity round

- Can also be used to raise funds needed to "bridge" a company to a later priced round

Less documentation compared to a priced round

- Fewer documents and terms to negotiate can mean faster execution and lower legal costs
- Note purchase agreement + notes or SAFE (+ pro rata letter)

May defer the need to establish a valuation of the company as no share price set

- Value can be determined by reference to the equity round (e.g., 20% discount to equity round price)

Maintain more founder control

- No stockholder voting rights
- Typically, no board seat with a SAFE/note investment, limited investor rights to extent they are negotiated (e.g., pro rata rights, information rights, observer rights, major investor status, MFN)

More flexibility for the company

- Allows for rolling closings without needing a lead investor to drive the round
- Stay outstanding until trigger event for conversion or repayment (or maturity, for notes)

Potential Drawbacks to Convertible Notes or SAFEs?

Founders can be surprised by excessive dilution in the future priced round

- Discuss the anticipated raise size and help the company understand (model) what the dilution might look like to founders, especially if a post-money SAFE with valuation cap is used, or if there is a larger size raise, or more than one round of convertible notes or SAFEs

Company may still need to set an effective valuation of the company

- If there is a valuation cap in the convertible note or SAFE, the company can't punt on the valuation discussion as much as it might have expected

No document precedent set with the earliest investors

- Lead investor in a priced round will have more leverage than earliest investors who may have been inclined to be more deferential to founders

A large amount of outstanding convertible notes/SAFEs requires a sizeable enough priced round

- Lead investor in priced round will likely want to hold majority of preferred stock and voting control

DIY SAFEs = headaches for lawyers later

- Anyone can issue them, and they can be very attractive tools for raising funds quickly

Common Terms – Discounts and Valuation Caps

- **Conversion to Equity in a Financing**
  - SAFEs and convertible notes are designed to automatically convert into shares of preferred stock in connection with a priced equity financing (e.g., a Series A financing)
    - Convertible Notes: usually have a definition of a "Qualified Financing", which sets a minimum amount that needs to be raised by the company for the notes to automatically convert
    - SAFEs: definition of "Equity Financing" does not contemplate a minimum raise amount, it only needs to be a priced preferred stock sale
- **Conversion at a Discount**
  - SAFEs and convertible notes may provide that they will convert to next round securities at a discount to the price paid by the new money investors in the equity financing (often a 10-30% discount)
- **Conversion at a Valuation Cap**
  - SAFEs and convertible notes may include a valuation cap
  - A valuation cap is a maximum valuation at which the SAFE or convertible note will convert into shares
  - A lower valuation cap is more favorable to the investor (i.e., assuming the valuation cap is hit, the instrument will convert into a greater number of shares the lower the valuation cap is)

Common Terms – SAFE Forms

- **Current YC SAFE forms at https://www.ycombinator.com/documents**
  - Post-Money Valuation Cap, no Discount
  - Discount, no Valuation Cap
  - MFN, no Valuation Cap, no Discount
  - Pro Rata Side Letter
  - Non-US forms (Canada, Caymans, Singapore)

- **YC SAFE forms (no longer on their website)**
  - Valuation Cap and Discount (Post-Money or Pre-Money)
  - Pre-Money Valuation Cap, no Discount

- **Carta has forms of Pre-Money and Post-Money SAFEs**

- **Law firms may have their own tailored version of Pre-Money and Post-Money SAFEs**

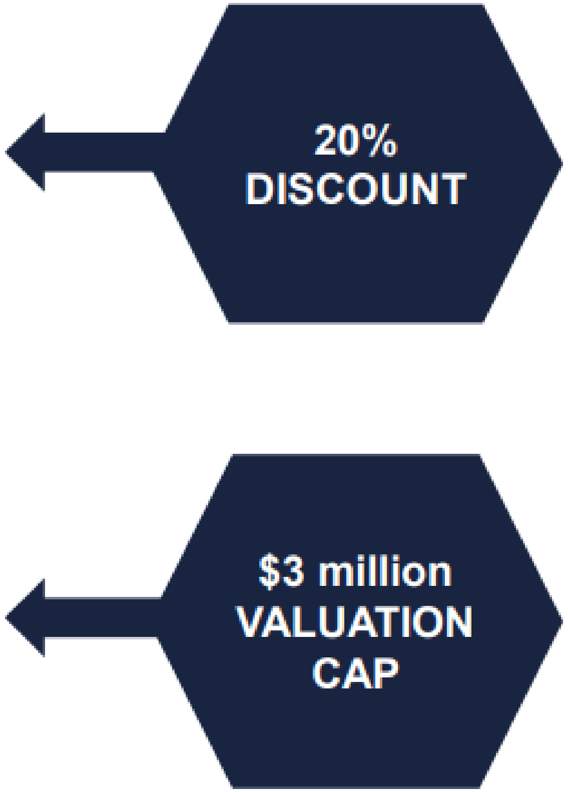
Common Terms (Cont.) – Conversion Price

Valuation caps and discounts can work together, giving the investor the most beneficial conversion terms, as in the below example from a convertible note:

1.6 "***Note Conversion Price***" means the lesser of:

(a) the product obtained by multiplying 0.8 times the lowest per share purchase price paid in cash for the Qualified Financing Securities or Non-Qualified Financing Securities, as applicable, issued to the investors in the applicable Conversion Financing; or

(b) the quotient obtained by dividing (1) the Valuation Cap by (2) the Company's fully diluted capitalization immediately prior to the initial closing of the Conversion Financing (assuming, without duplication, full conversion or exercise of all outstanding convertible or exercisable securities, rights, options and warrants, and the issuance of all shares reserved for grant pursuant to the Company's equity incentive plans) (such quotient, the "***Cap Price***"). For the purposes hereof, the "***Valuation Cap***" shall mean $3,000,000.



The "Company Capitalization" Definition is Key to the Valuation Cap

From a YC SAFE with a Post-Money Valuation Cap:

"**Company Capitalization**" is calculated as of immediately prior to the Equity Financing and (without double-counting, in each case calculated on an as-converted to Common Stock basis):

- Includes all shares of Capital Stock issued and outstanding;
- Includes all Converting Securities;
- Includes all (i) issued and outstanding Options and (ii) Promised Options; and
- Includes the Unissued Option Pool, except that any increase to the Unissued Option Pool in connection with the Equity Financing will only be included to the extent that the number of Promised Options exceeds the Unissued Option Pool prior to such increase.

"**Converting Securities**" includes this Safe and other convertible securities issued by the Company, including but not limited to: (i) other Safes; (ii) convertible promissory notes and other convertible debt instruments; and (iii) convertible securities that have the right to convert into shares of Capital Stock.

From a Carta-generated SAFE with a Pre-Money Valuation Cap:

"**Pre-Money Valuation Cap Denominator**" means, immediately prior to the Qualified Financing, the sum of (without double-counting, in each case calculated on an as-converted to Common Stock basis):

1. All issued and outstanding shares of the Company's capital stock, including, without limitation, "**Common Stock**" and "**Preferred Stock**" ("**Capital Stock**").
2. All (i) issued and outstanding options, restricted stock awards or purchases, RSUs, SARs, warrants or similar securities, vested or unvested (collectively, "**Options**"), (ii) Promised Options, (iii) the Unissued Option Pool, (iv) any increase to the Unissued Option Pool in connection with the Qualified Financing, and (v) any equity incentive or similar plan to be created in connection with the Qualified Financing.
3. All shares issuable upon exercise or conversion of any convertible securities, excluding (a) this SAFE, (b) any other instruments containing a future right to shares of Capital Stock, similar in form and content to this instrument, purchased by investors for the purpose of funding the Company's business operations ("**SAFEs**") issued by the Company and (c) any convertible promissory notes issued by the Company.

Conversion Price Per Share =

$$\frac{\$\ \text{Valuation Cap}}{\text{Company Capitalization*}}$$

***pay attention to what is included in the denominator!**

"Company Capitalization" Definition (Cont.)

- The Post-Money Valuation Cap is "post" all of the SAFE money that has been raised
- The Post-Money Valuation Cap is also "post" the options and option pool existing prior to the equity financing, but excludes the new or increased option pool in the equity financing
- <u>The Post-Money Valuation Cap is still before (pre) the new money in the priced round; the SAFE holders are diluted in the priced round</u>

- Post-Money Valuation Cap allows SAFE investors to lock in the percentage of the company they will own just before the priced equity round
  - *E.g.*, $1 million raised at a $5 million post-money valuation cap = SAFE investors own 20% of the company immediately prior to the priced round
  - SAFE investors will not be diluted if the company issues additional SAFEs/notes before their SAFE converts, but the founders (and any other existing stockholders) are diluted
- <u>SAFEs on YC website all "Post-Money" forms</u>, but Pre-Money Valuation Cap SAFEs are still used and advantageous to companies (especially if they might raise more than expected)

- Historically uncommon for note rounds to use a fixed post-money concept, but we are seeing it more often now that the approach has become more market-standard in SAFEs

What is “Shadow” Preferred Stock?

- **Shadow Preferred Stock**
  - It is one or more separate series of preferred stock for the converting notes or SAFEs (e.g. Seed-1, Seed-2, Seed-3).
  - Shadow preferred has identical rights to the preferred stock being sold in the equity financing, except that the liquidation preference, initial conversion price and dividend rate are based on the price per share at which the notes or SAFEs are converting
  - Shadow preferred solves the problem of liquidation overhang associated with convertible notes and SAFEs because investors still get shares at the discounted price, but their liquidation preference will not exceed their original investment amount.
  - See below example for a SAFE:

“**Safe Preferred Stock**” means the shares of the series of Preferred Stock issued to the Investor in an Equity Financing, having the identical rights, privileges, preferences, seniority, liquidation multiple and restrictions as the shares of Standard Preferred Stock, except that any price-based preferences (such as the per share liquidation amount, initial conversion price and per share dividend amount) will be based on the Safe Price.

“**Standard Preferred Stock**” means the shares of the series of Preferred Stock issued to the investors investing new money in the Company in connection with the initial closing of the Equity Financing.

Sample Conversion Scenario – Convertible Note

So you've been asked to model or review a model in connection with a priced round with converting securities …

In this scenario, the Series A investors are investing $2,000,000 at a $8,000,000 pre-money valuation, for 20% of the company. They have also agreed to a 15% post-money option pool target.

The existing Convertible Notes will convert at the lesser of (i) a 20% discount to the Series A price or (ii) the price per share assuming a $3,000,000 valuation.

PortCo, Inc.
Series A Pro Forma

Series A Inputs	
Valuation (pre-$)	$ 8,000,000
New $$	$ 2,000,000
Option pool target %	15.0%
FD capitalization	11,995,415
PPS (Series A)	$ 0.6669
PPS (Series A-1)	$ 0.2792

Current Capitalization

Post-Financing

Name	Common Stock		Preferred Stock					Total		
			Series A			Series A-1				
			$$							
	Shares	Options	Target	Actual	Shares	$$	Shares	Shares	%	
Existing stakeholders										
Founder 1	4,000,000							4,000,000	26.7%	
Founder 2	4,000,000							4,000,000	26.7%	
Employee 1		1,000,000						1,000,000	6.7%	
Noteholders										
Noteholder 1						$ 104,178.08	373,130	373,130	2.5%	
Noteholder 2						$ 104,178.08	373,130	373,130	2.5%	
Series A Investors										
Lead investor			$ 2,000,000	$1,999,999.76	2,998,950			2,998,950	20.0%	
Option Plan										
Existing available		1,000,000						1,000,000	6.7%	15.0%
Increase		1,249,155						1,249,155	8.3%	
	8,000,000	3,249,155	$ 2,000,000	$1,999,999.76	2,998,950	$ 208,356.16	746,260	14,994,365	100.0%	

1.6 "***Note Conversion Price***" means the lesser of:

(a) the product obtained by multiplying 0.8 times the lowest per share purchase price paid in cash for the Qualified Financing Securities or Non-Qualified Financing Securities, as applicable, issued to the investors in the applicable Conversion Financing; or

(b) the quotient obtained by dividing (1) the Valuation Cap by (2) the Company's fully diluted capitalization immediately prior to the initial closing of the Conversion Financing (assuming, without duplication, full conversion or exercise of all outstanding convertible or exercisable securities, rights, options and warrants, and the issuance of all shares reserved for grant pursuant to the Company's equity incentive plans) (such quotient, the "***Cap Price***"). For the purposes hereof, the "***Valuation Cap***" shall mean $3,000,000.

Convertible Notes

Name	Principal		Interest					Total $$	Cap			Discount	
	Note	Principal	Rate	Issue Date	Conv. Date	Days	$		Valuation Cap	FD capitalization	PPS	%	PPS
Noteholder 1	CN-01	$ 100,000.00	5.0%	2023-07-20	2024-05-20	305	$ 4,178.08	$ 104,178.08	$ 3,000,000	10,746,260	$ 0.2792	20.0%	$ 0.5335
Noteholder 2	CN-02	$ 100,000.00	5.0%	2023-07-20	2024-05-20	305	$ 4,178.08	$ 104,178.08	$ 3,000,000	10,746,260	$ 0.2792	20.0%	$ 0.5335
		$ 200,000.00					$ 8,356.16	$ 208,356.16					

Sample Conversion Scenario – SAFE

So you've been asked to model or review a model in connection with a priced round with converting securities …

In this scenario, the Series A investors are investing $2,000,000 at a $8,000,000 pre-money valuation, for 20% of the company. They have also agreed to a 15% post-money option pool target.

The existing SAFEs will convert at the lesser of (i) a 20% discount to the Series A price or (ii) the price per share assuming a $3,000,000 valuation.

PortCo, Inc.
Series A Pro Forma

Series A Inputs	
Valuation (pre-$)	$ 8,000,000
New $$	$ 2,000,000
Option pool target %	15.0%
FD capitalization	11,956,056
PPS (Series A)	$ 0.6691
PPS (Series A-1)	$ 0.2800

Current Capitalization | Post-Financing

Name	Common Stock		Preferred Stock					Total	
			Series A			Series A-1			
			$$						
	Shares	Options	Target	Actual	Shares	$$	Shares	Shares	%
Existing stakeholders									
Founder 1	4,000,000							4,000,000	26.8%
Founder 2	4,000,000							4,000,000	26.8%
Employee 1		1,000,000						1,000,000	6.7%
SAFE Holders									
SAFE holder 1						$ 100,000.00	357,142	357,142	2.4%
SAFE holder 2						$ 100,000.00	357,142	357,142	2.4%
Series A Investors									
Lead investor			$ 2,000,000	$ 1,999,999.45	2,989,089			2,989,089	20.0%
Option Plan									
Existing available		1,000,000						1,000,000	6.7%
Increase		1,241,772						1,241,772	8.3%
	8,000,000	3,241,772	$ 2,000,000	$ 1,999,999.45	2,989,089	$ 200,000.00	714,284	14,945,145	100.0%

SAFES

Name	Principal		Cap				Discount	
	SAFE	Principal	Valuation Cap		Company Capitalization	PPS	%	PPS
SAFE holder 1	SAFE-01	$ 100,000.00	$	3,000,000	10,714,284	$ 0.2800	20.0%	$ 0.5353
SAFE holder 2	SAFE-02	$ 100,000.00	$	3,000,000	10,714,284	$ 0.2800	20.0%	$ 0.5353

The "**Post-Money Valuation Cap**" is $3,000,000.

The "**Discount Rate**" is 80%.

"**Company Capitalization**" is calculated as of immediately prior to the Equity Financing and (without double-counting):

1. Includes all shares of Capital Stock issued and outstanding;
2. Includes all Converting Securities;
3. Includes all (i) issued and outstanding Options and (ii) Promised Options;
4. Includes the Unissued Option Pool; and
5. Excludes, notwithstanding the foregoing, any increases to the Unissued Option Pool (except to the extent necessary to cover Promised Options that exceed the Unissued Option Pool) in connection with the Equity Financing.

Other Terms – Additional Repayment/Conversion Events

- **Liquidity Event (IPO, Direct Listing, Change of Control)**
  - SAFE defined term is a “Liquidity Event”
    - Includes change of control, direct listing, or an IPO, giving investors greater of purchase amount or amount payable when converted at the “Liquidity Price”
  - Notes will also include a change of control and IPO concept
    - Notes may have a “change of control premium” that could include (i) a multiple of dollars of invested (*e.g.*,150% principal + interest), (ii) the amount of cash received as if note converted at its valuation cap or (iii) the greater of the two
- **Maturity (Notes only)**
  - Principal + interest repayment (often upon written election of majority noteholders)
  - Conversion
- **Dissolution of the Company**
  - Noteholders are creditors (secured or unsecured) senior to stockholders
  - SAFEs (latest YC form) are junior to outstanding indebtedness, on par with other SAFEs and preferred stock, senior to common stock

Other Terms - MFNs and Preemptive Rights

- **Most Favored Nation**
  - MFN provisions guarantee that existing holders benefit from any more favorable terms in future notes/SAFEs that the company may issue by allowing holders to amend SAFEs/notes to match the new terms
  - May be in the SAFE/note itself or in a side letter
- **Pro Rata (Preemptive) Rights**
  - Pro rata rights give investors the right (but not an obligation), to purchase a proportionate amount of any new securities issued by the company
    - Proportionate amount based on the investors existing ownership percentage
  - SAFEs: YC has a **pro rata side letter** that provides a one-time preemptive right for the SAFE holder in the priced round in which the SAFE converts
    - Older form YC SAFEs may have pro rata rights in the SAFE for pro rata rights in the round after the priced round in which SAFE converts – **check the form**!
    - Consider using the YC pro rata side letter or work with your supervising attorney to make your own letter when investor-side on a SAFE so you can add in other investor rights
  - Notes: Convertible notes may have pro rata rights in the NPA/note or negotiated in a separate side letter, needs to be negotiated, if investor-side, include in term sheet