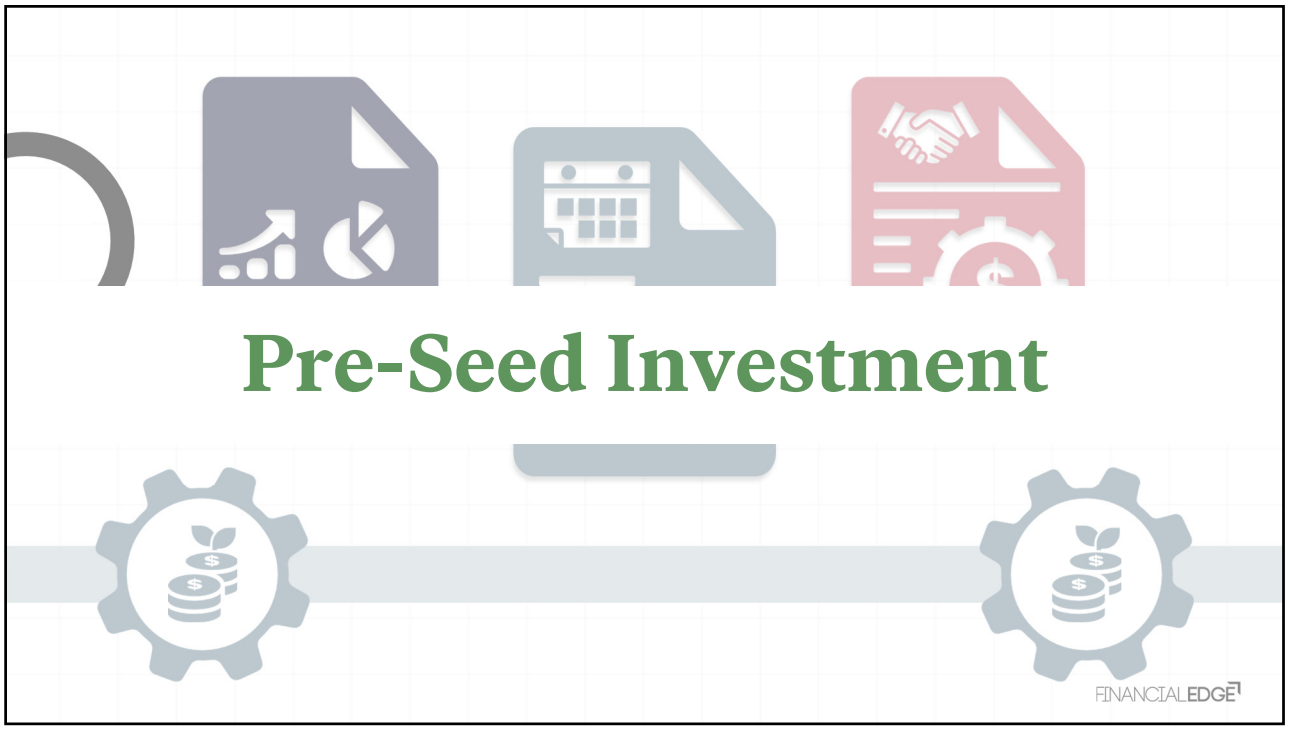

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Process term sheets (and risk and reward) of very early-stage investing

Isn't usually the **domain** of **venture capital** investing	Traditionally **pre-sales** and therefore **too early** for VC investment funds	May attract some **institutional investment**	Funding rounds are usually **unpriced**

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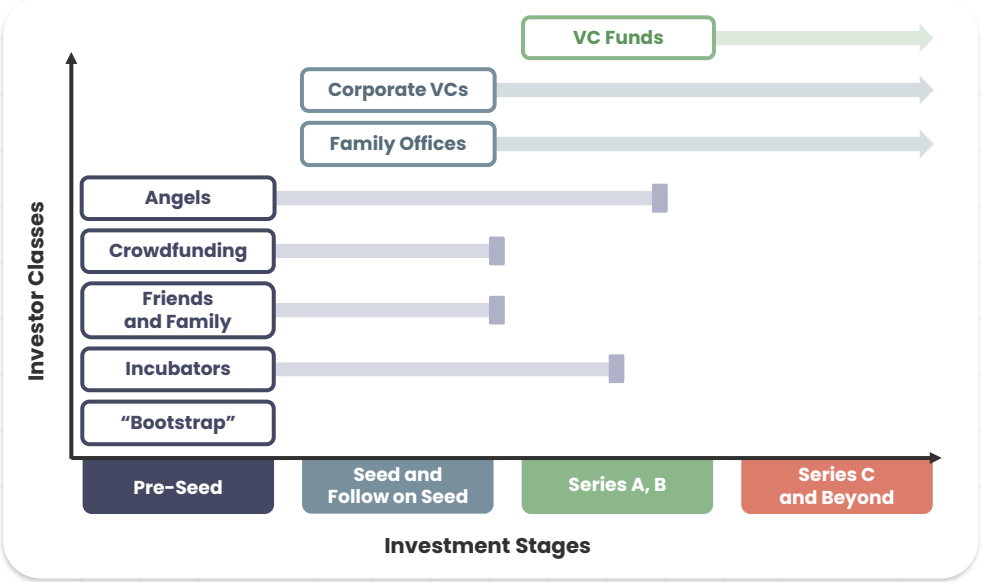

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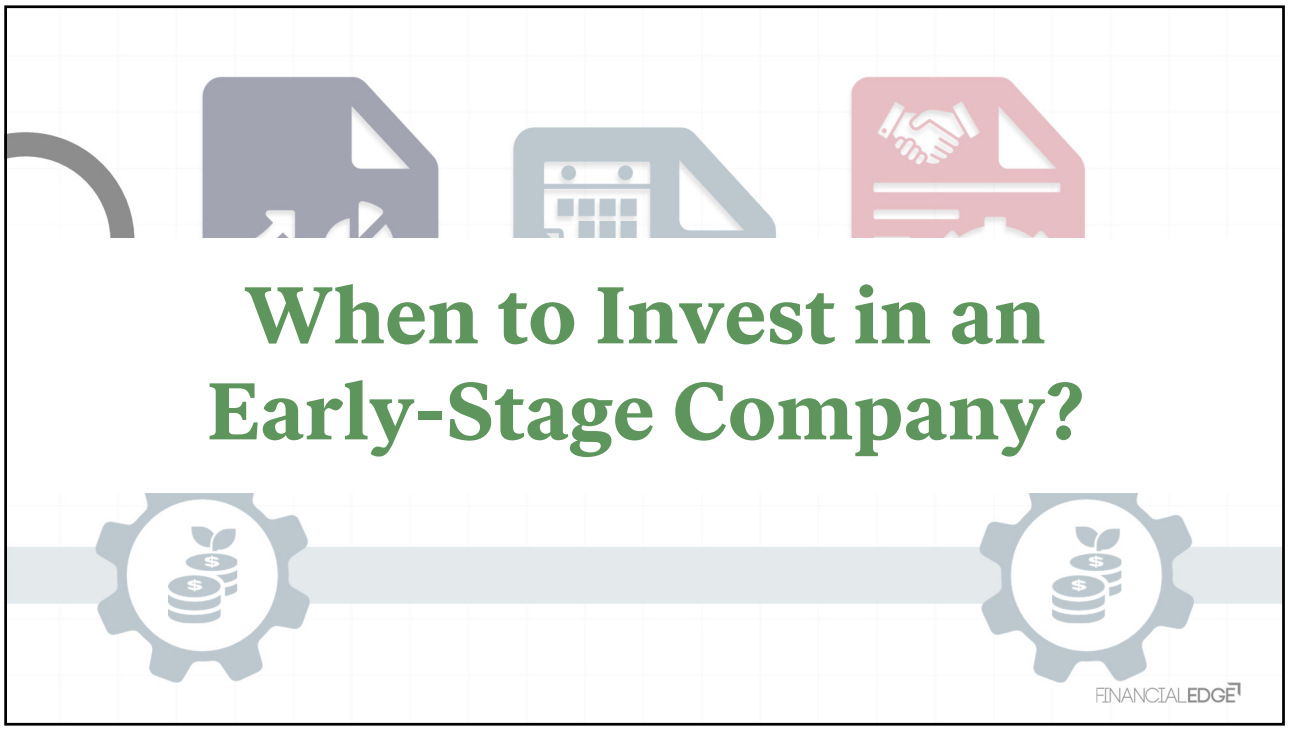

Seeking Early-Stage Investment

SEED STAGE

- Company or business model is very new
- Still determining proof of concept
- Needs investment for growth (Pre-sales and no near-term profitability)
- Hard to determine a valuation
- Attract investors with access to equity at a price determined in the future

Seeking Late-Stage Investment

SERIES A FUNDING ROUND AND BEYOND

- Company established and conducting business
- Generating sales and hopefully profits
- Client base determined
- Needs investment for growth
- Easier to determine a valuation
- Attract investors with a set valuation and by offering equity

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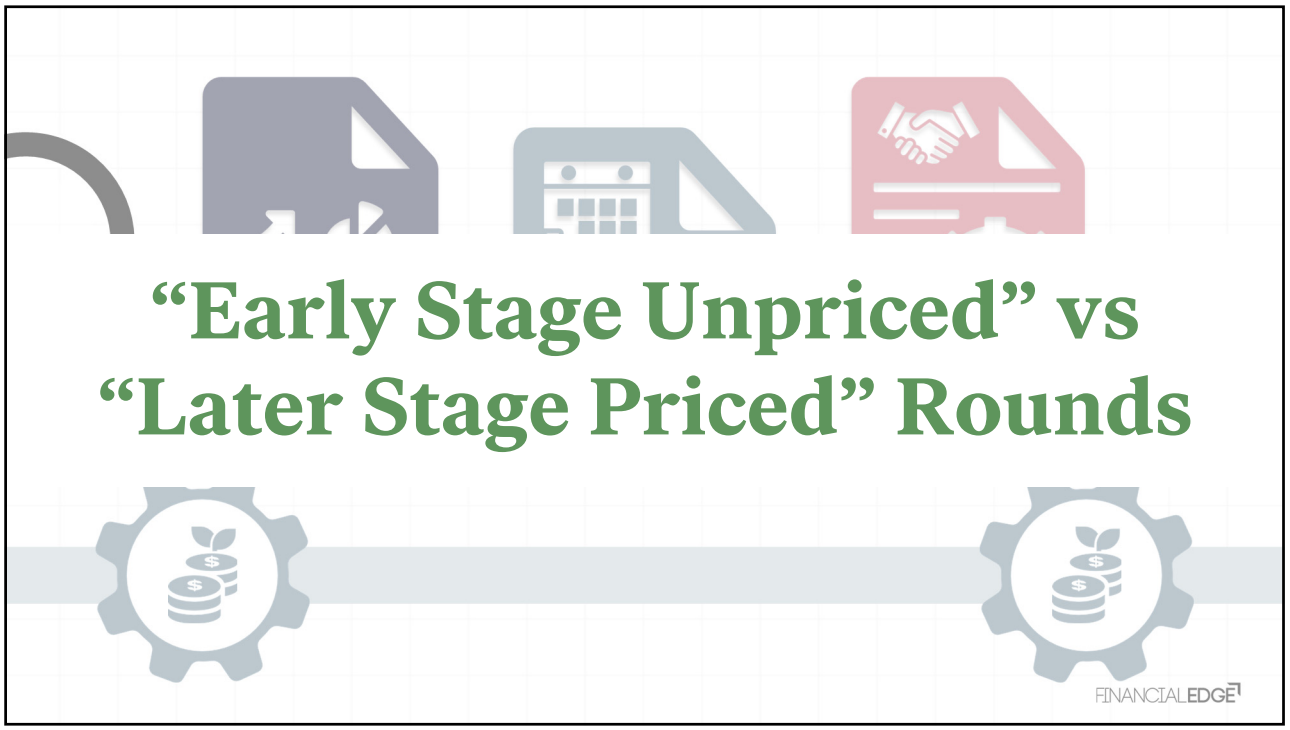

"Priced" Round

- Typical for a company **AFTER** early-stage investment (seed) rounds
- Conventional way to **invest**, based on revenue, profits and cash flows
- Agreeing a **valuation with investors is easier**
- Signed Agreement — **Investors purchase shares** in the company at a price determined by that **valuation**

"Unpriced" Round

- Suitable for **very early-stage** investing
- The startup company is NOT given a **valuation**
- Signed Agreement — **Investors** are not purchasing a **known amount of equity shares**
- Investors provide **capital now** for the **purchase of shares** in a **FUTURE priced round**

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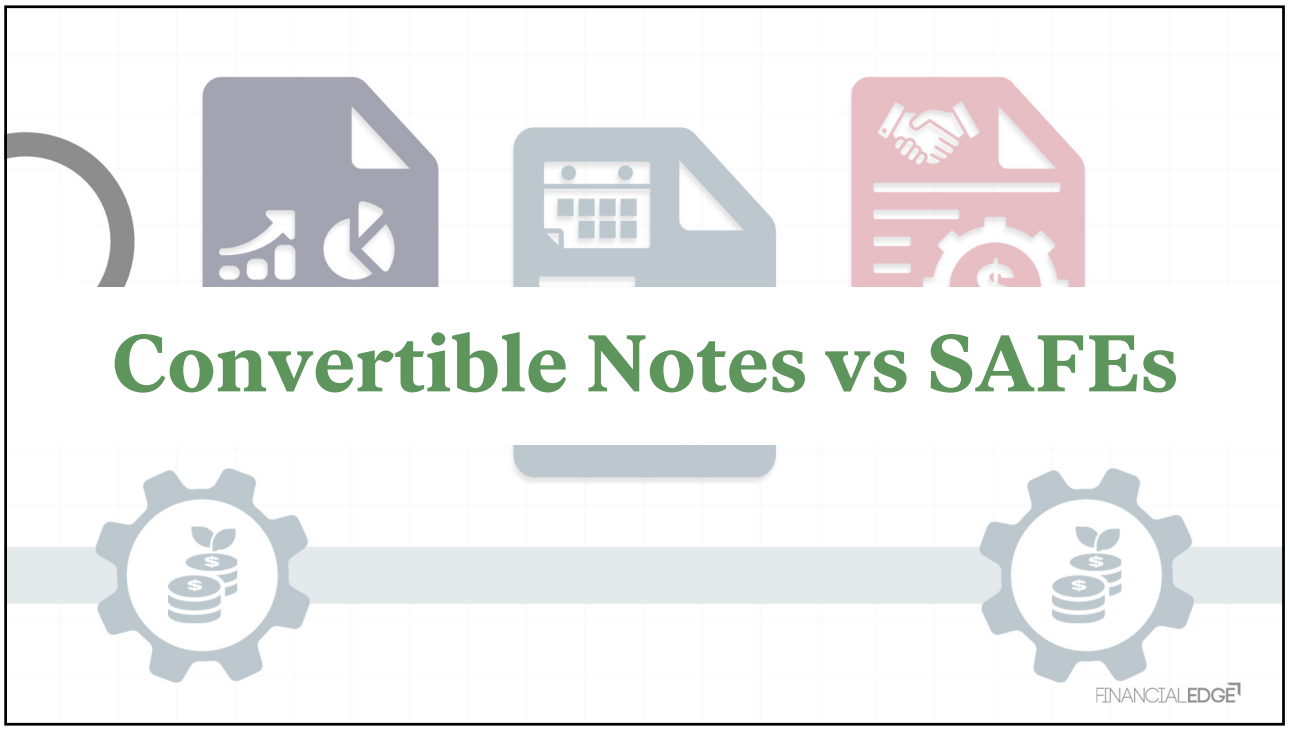

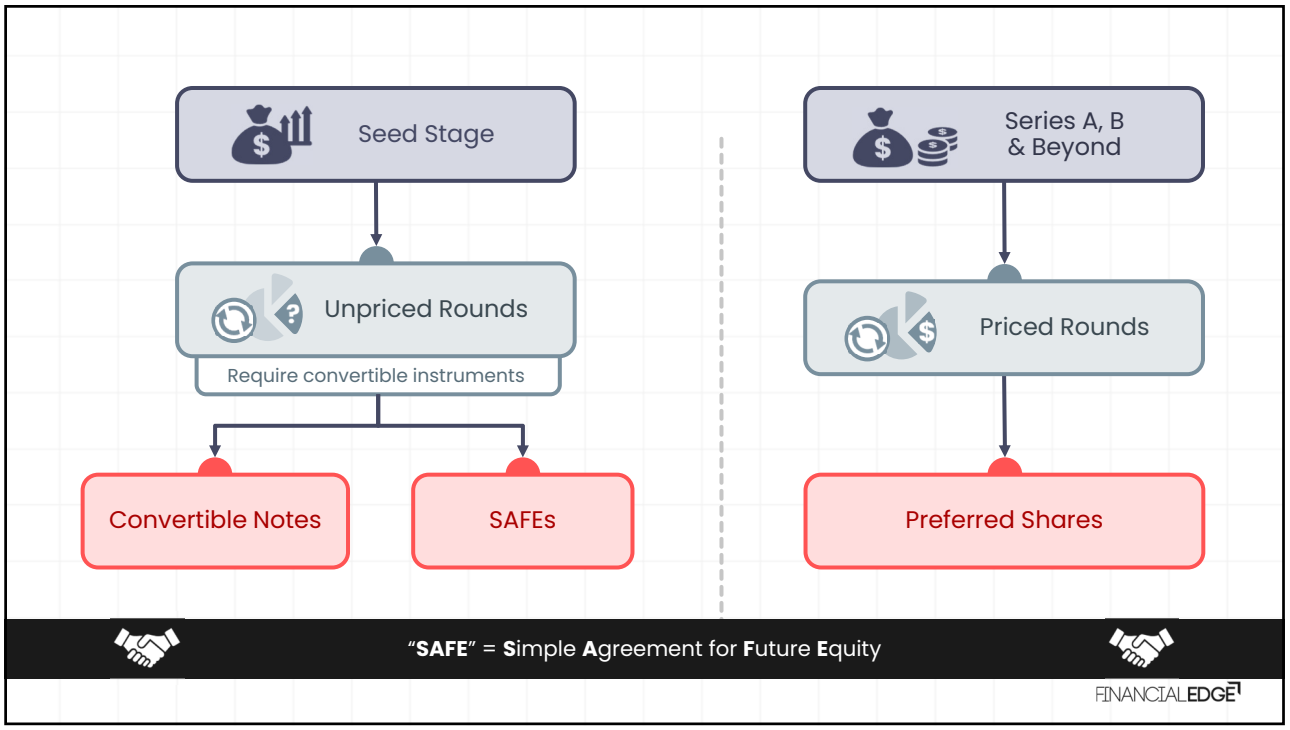

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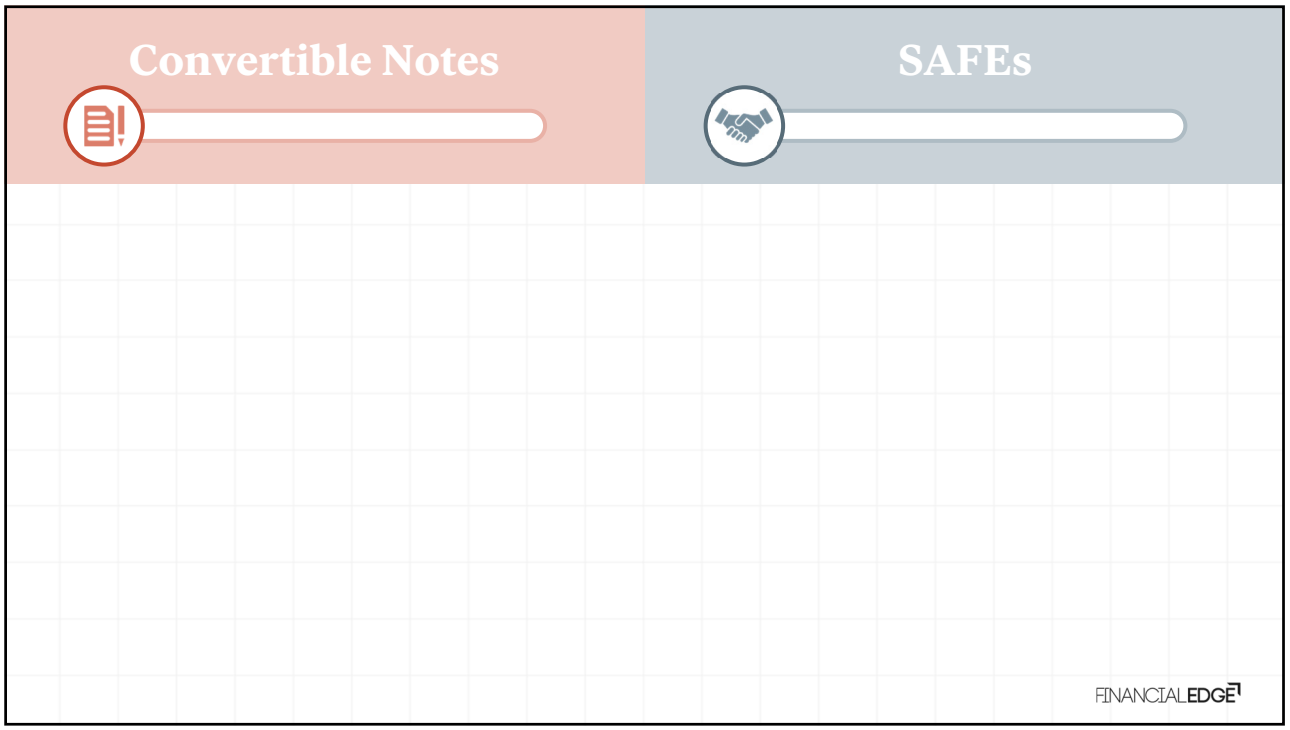

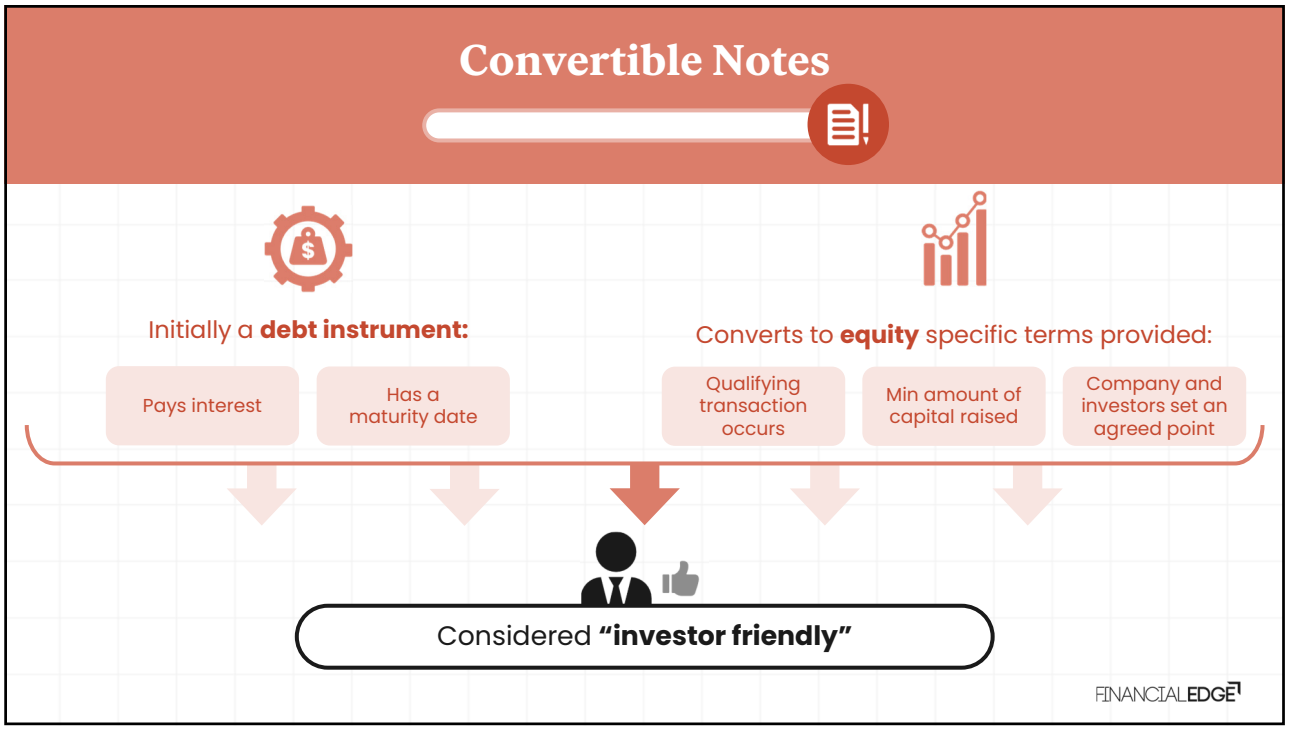

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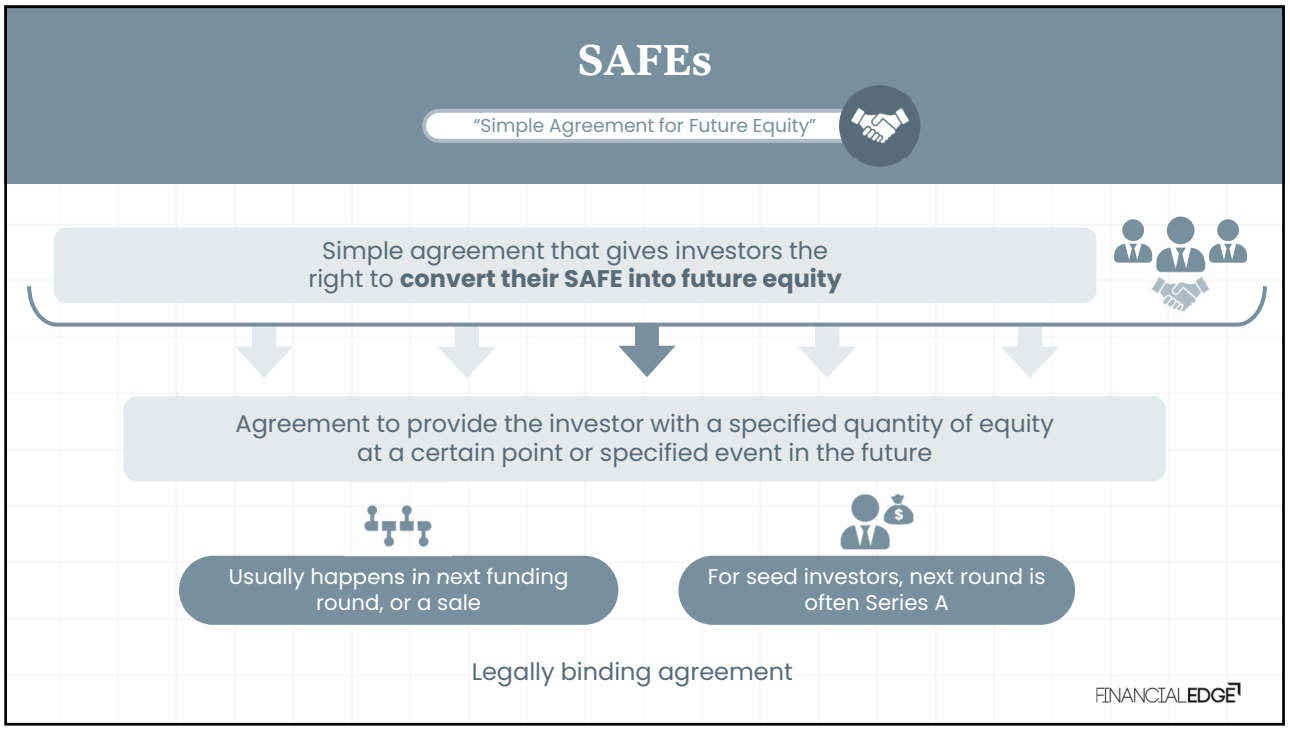

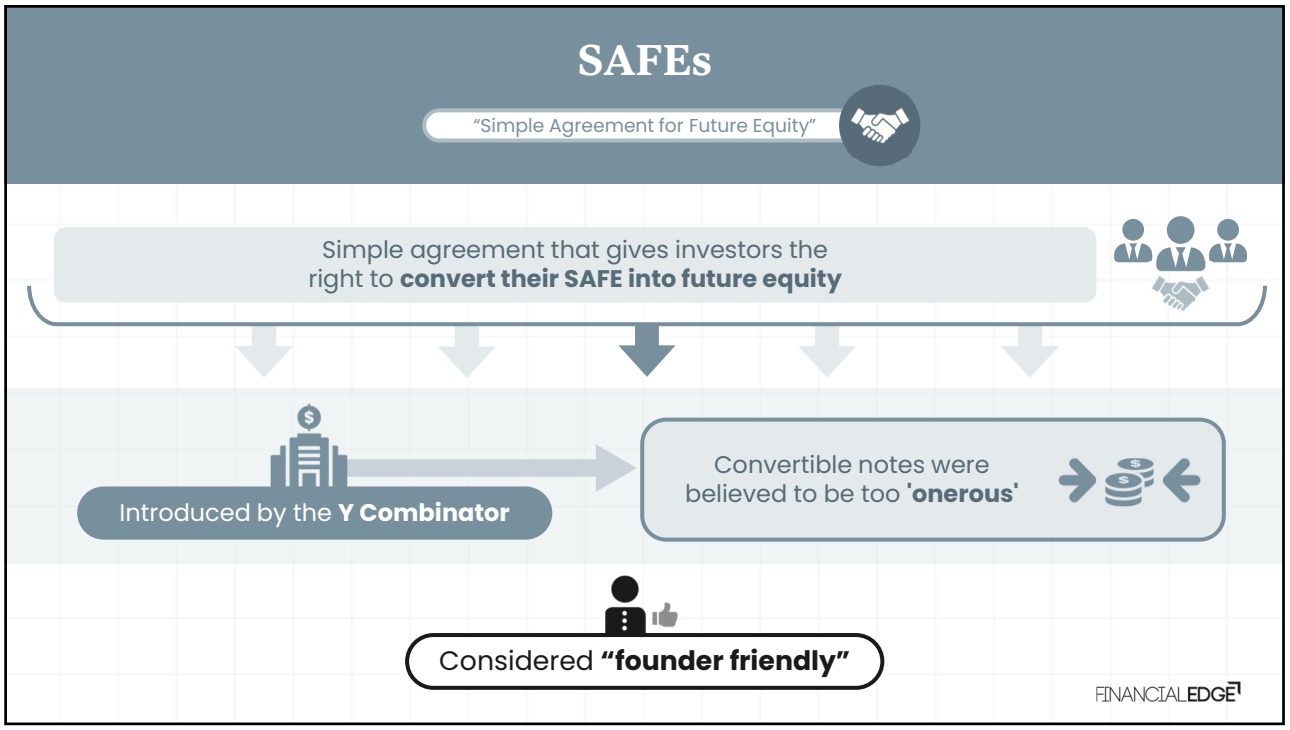

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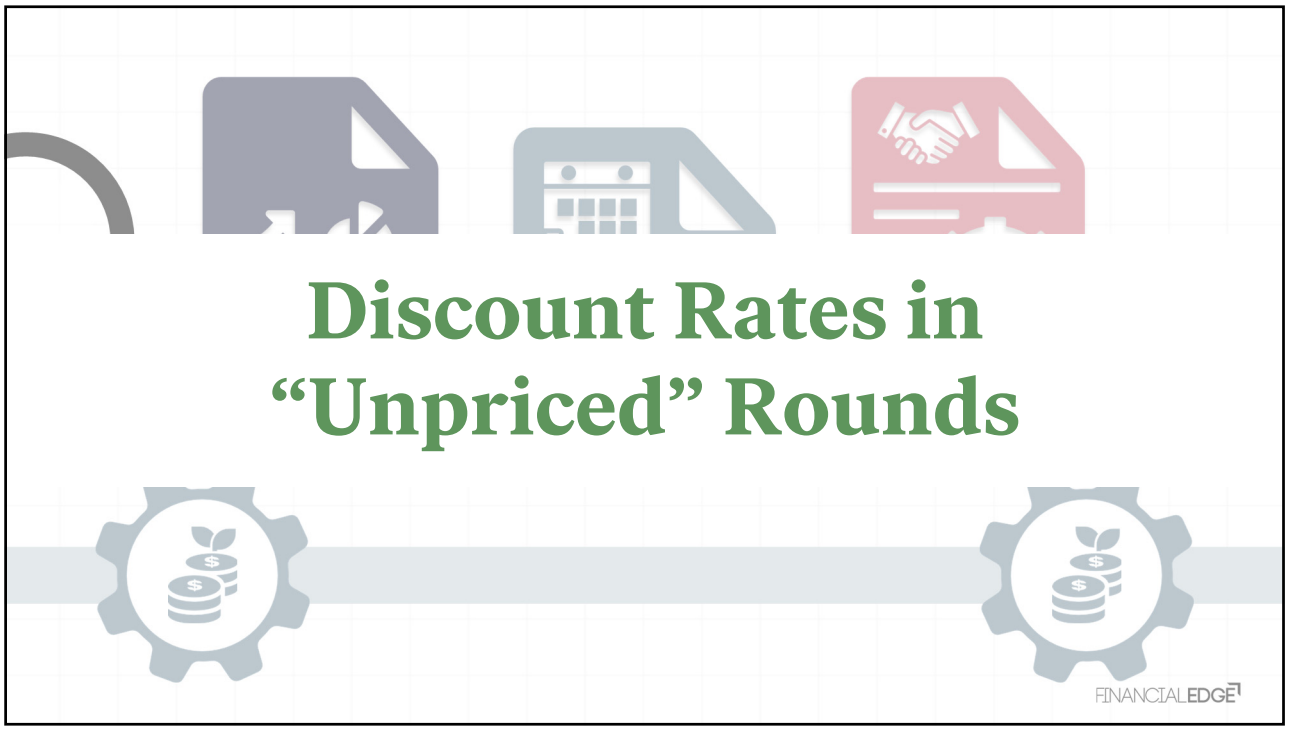

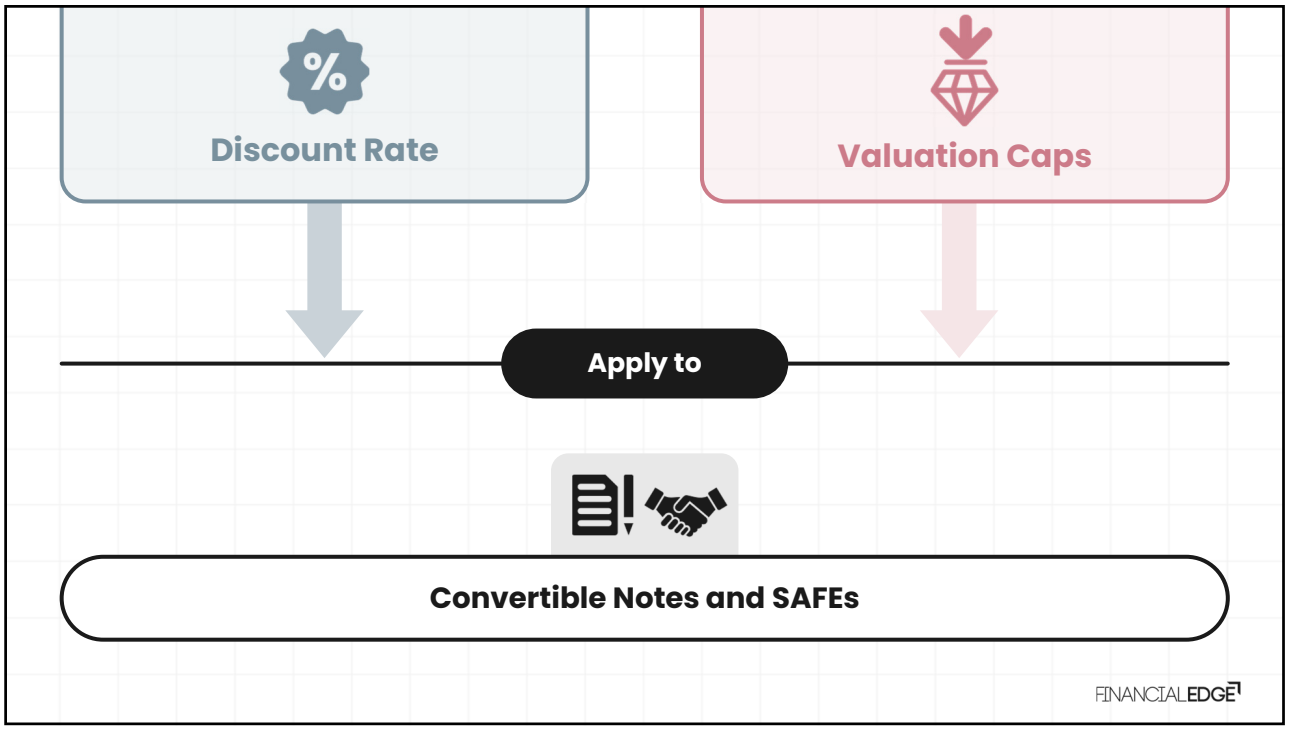

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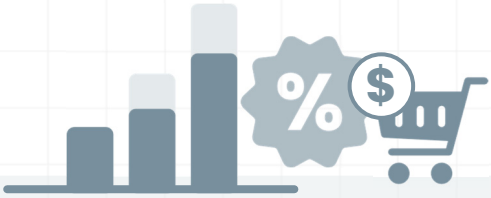
Discount Rate

Valuation Caps



Percentage discount to the **price of shares** that a **seed stage investor** can **purchase** in the next **priced round**

Able to **buy shares** at a **LOWER** price than **other new investors**

Discount Rate is usually in the range of **5-30%**

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Example of a Discount Rate

	Seed (unpriced)	**Series A Funding Period** (priced)
Other Investors	✕	Invest at price of **$1** per share
Seed Investors	Invest through convertibles or **SAFEs**	Invest at 20% **discounted** price of **$0.80**

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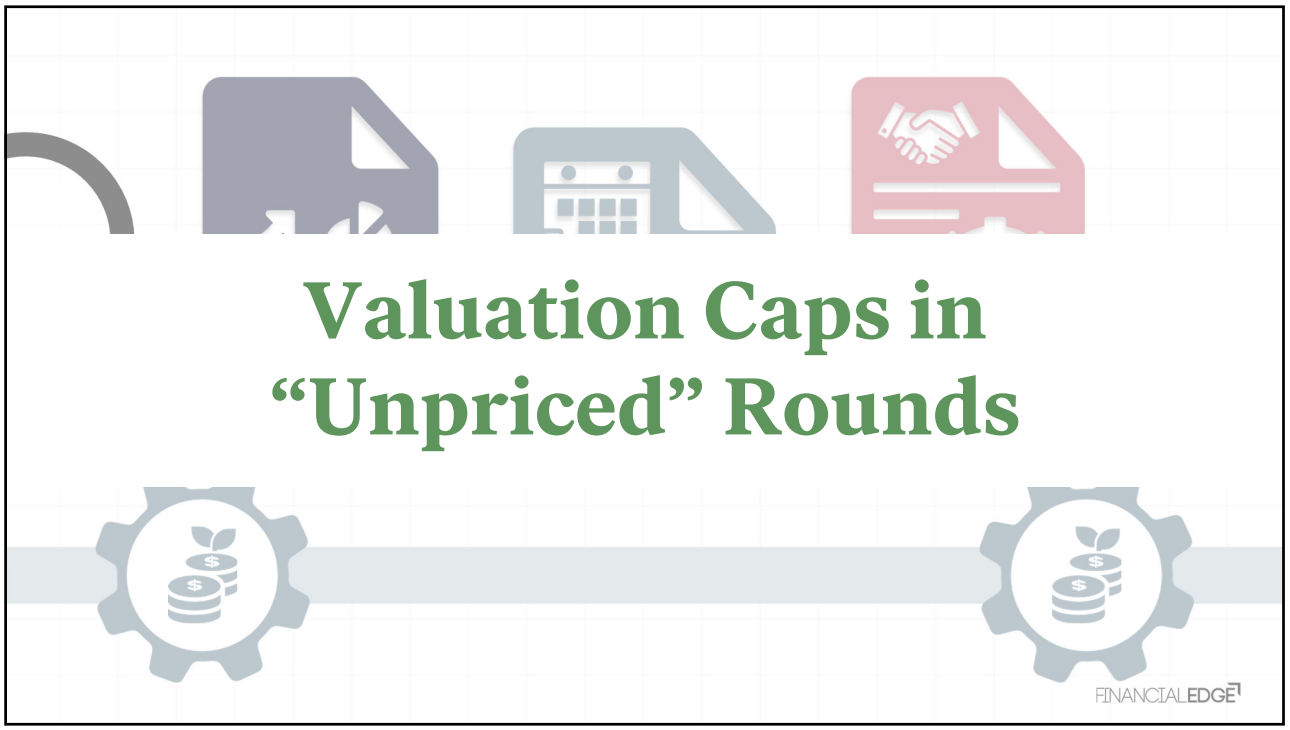

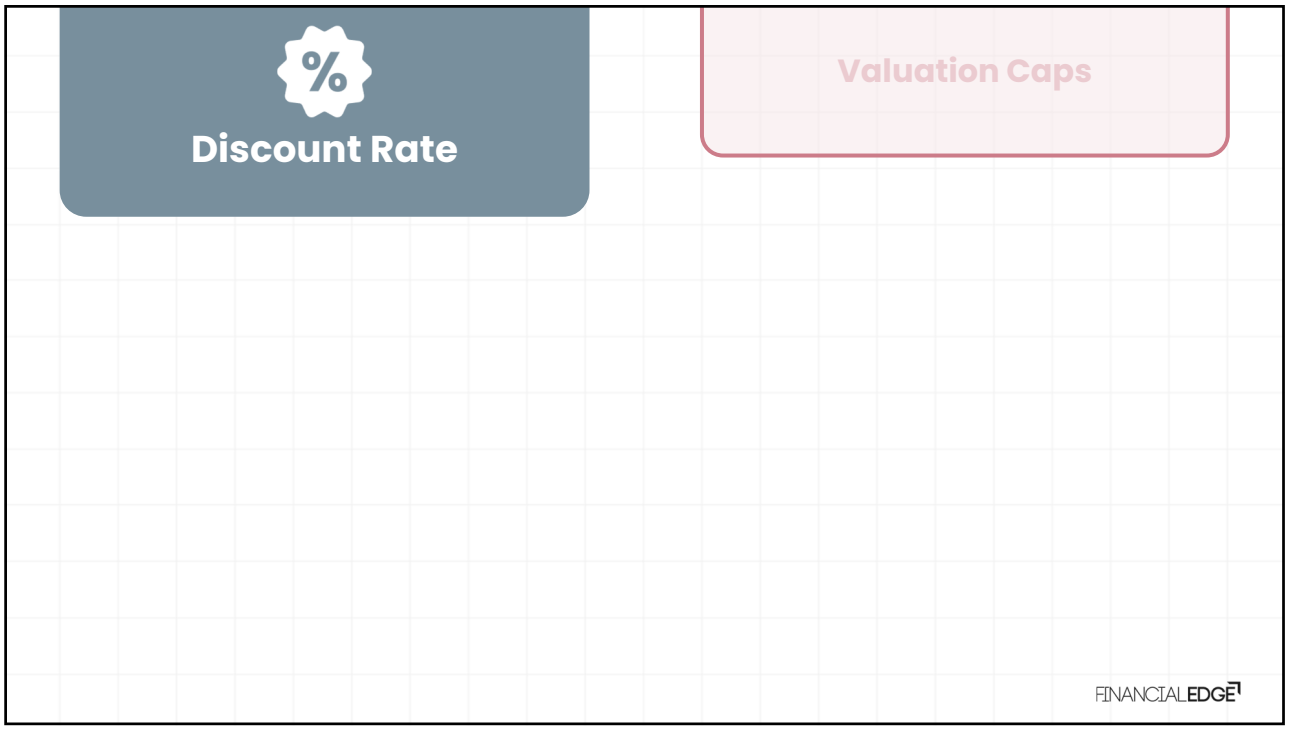

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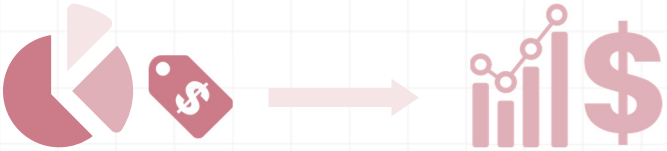
Discount Rate

Valuation Caps

A valuation cap is a **ceiling** or **cap** on the **valuation of the company**



Ceiling on how **high** the **company valuation** will go before **investment** is **converted into equity**

Occurs even if new **investors** in the **priced round** agree to and pay a **higher price per share** based on a **higher valuation**

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Discount Rate

Valuation Caps

Acts as a **price ceiling**

New Investors

High price

Convertible Note or SAFE Investors

Lower CAPPED price

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Discount Rate

Valuation Caps

Ensures seed investors get a **certain percentage share of a company**

Prevents an **excessively high valuation** from squeezing the **percentage share lower**

A valuation cap is one of the most **appealing aspects for seed investors**

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Example of a Valuation Cap

	Convertible Note or SAFE Investment	Valuation Cap	"Unpriced" Valuation	Equity Ownership
Early-Stage Investor (Unpriced)	$100,000	$800,000	TBC	TBC
Next Funding Round (Priced)	$100,000	$800,000	$1.5m	1/8th ($187,500 equity)

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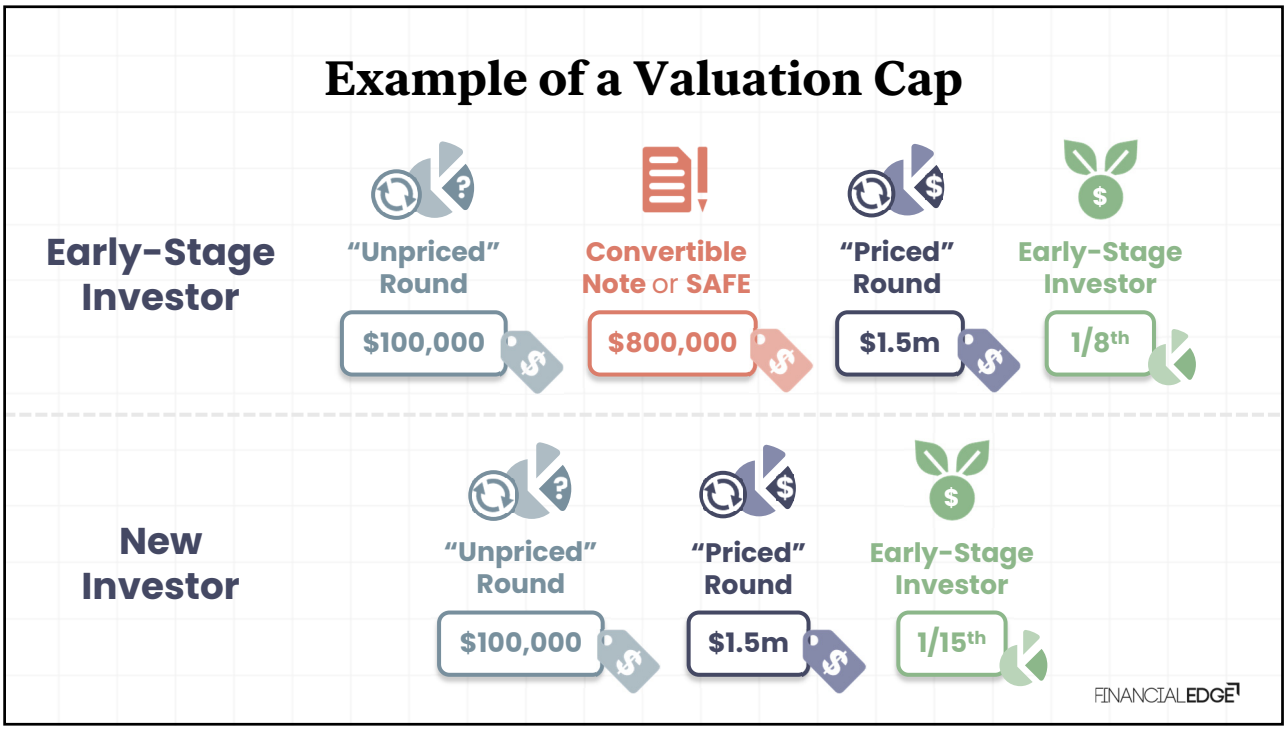
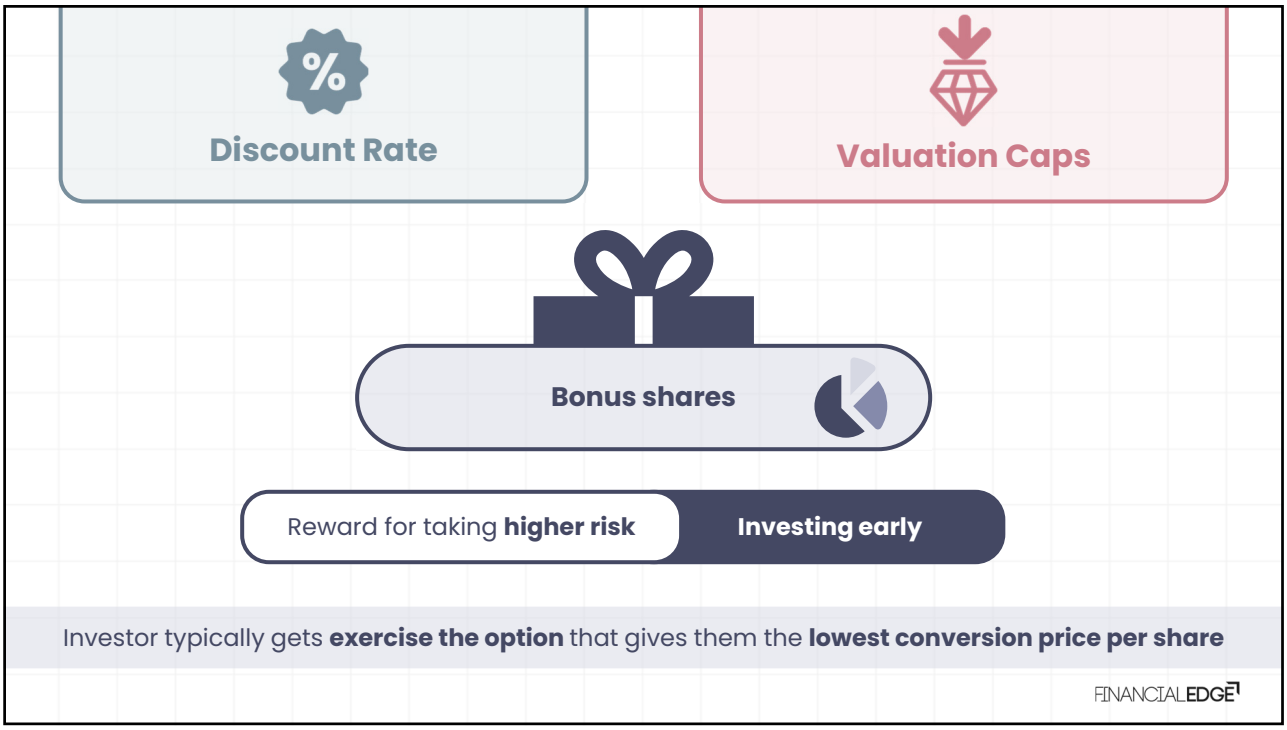
Example of a Valuation Cap





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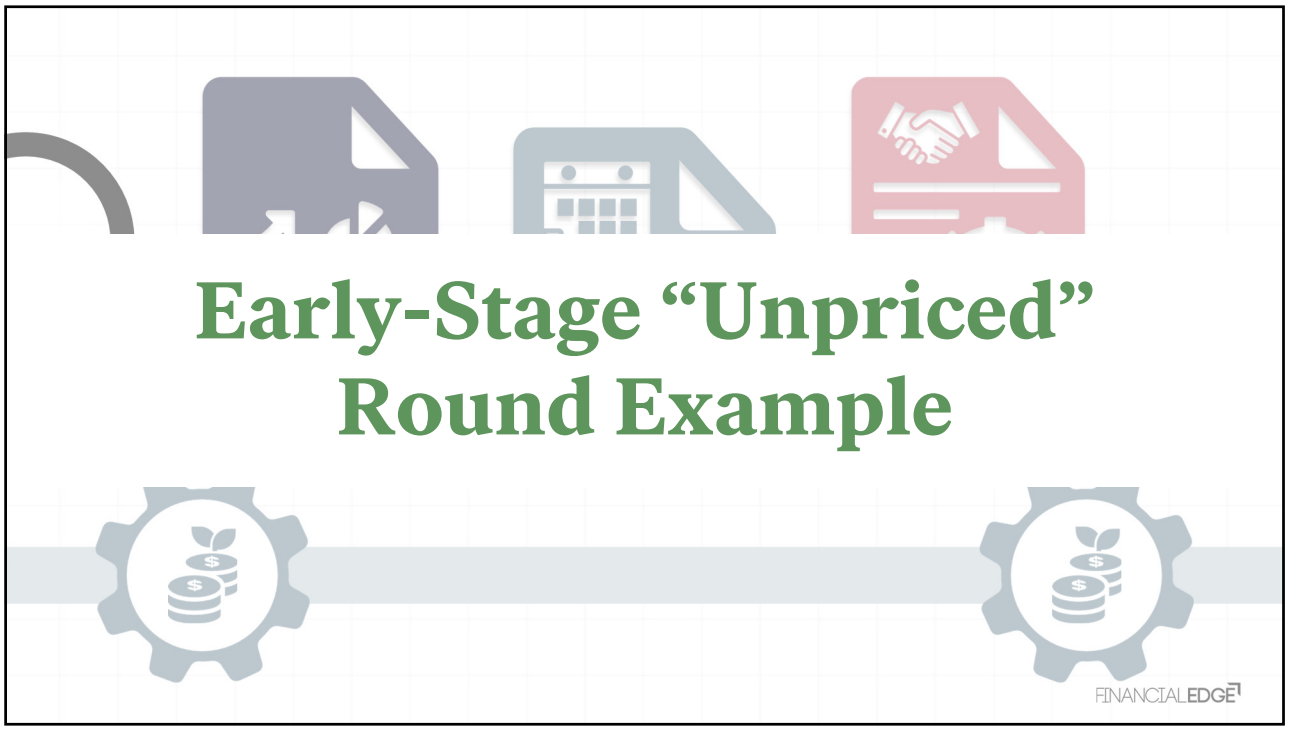

Initial Capitalization	$10mm Common Shares at $1/Share		
Unpriced Round	$1.5mm Seed Round, Unpriced SAFE		
	Initial Investment	Discount Rate	Valuation Cap
Investor A	$500,000	20%	-
Investor B	$500,000	-	$10mm
Investor C	$500,000	20%	$10mm

Priced Round	$10mm Series A Round, $15mm Pre Money, $1.50/Share		
	Conversion Price / Share		No. of Shares
Investor A	$1.20	($1.50 x (1-20%))	416,667 ($500k / 1.20)
Investor B	$1.00	($10mm / 10mm)	500,000 ($500k / 1.00)
Investor C	$1.00		500,000

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Most Favored Nation ("MFN") Clause in SAFEs

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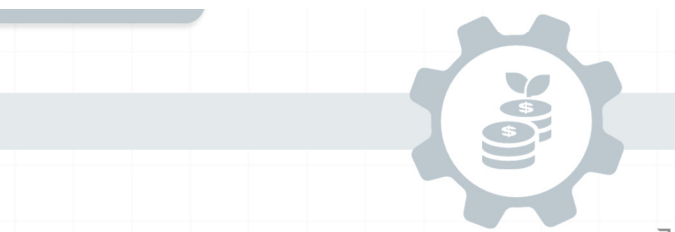
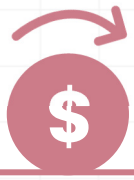


Most Favored Nation Clause

MFN clause allows **early investors to request** and **receive identical provisions** included in later issued notes, particularly if they are considered **more favorable**



Included in SAFEs

They lend themselves more to a **fundraising process** on a **"rolling basis"**

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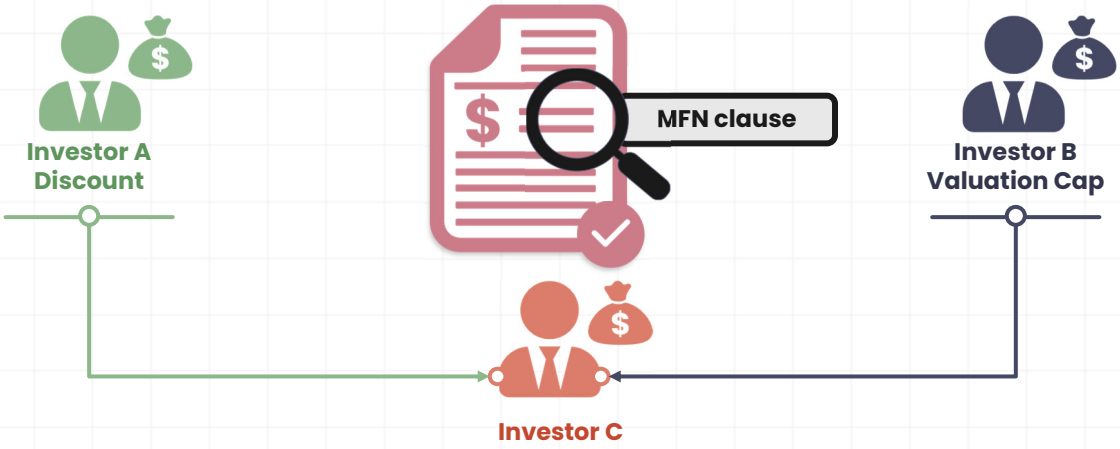
Three investors **invest** in an early-stage company at **different times**, each receiving a **different reward**



If **Investor A** and **B** had the **MFN clause in their SAFE,** then they would receive the **same terms as Investor C**

It would allow them to **CHOOSE** between the **discount rate** and the **valuation rate, whichever is best**

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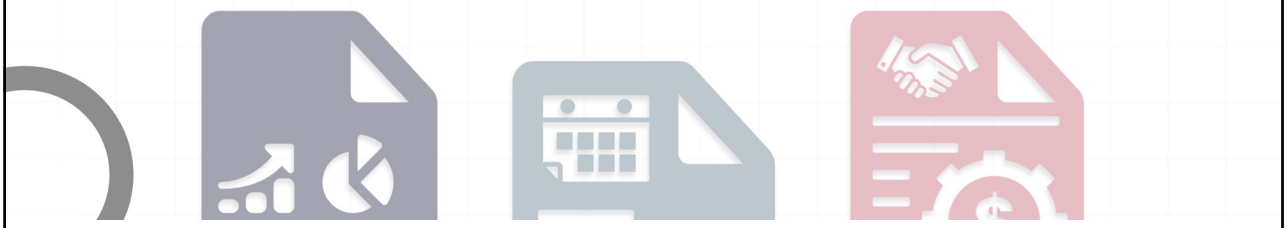
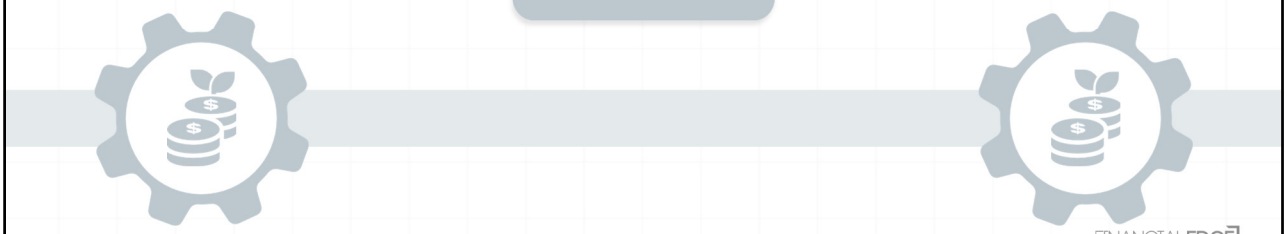


Pro Rata Rights



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Pro Rata Rights

Allow seed investors to **invest additional funds**

Maintain their **percentage ownership** of the company

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Pro Rata Rights

Without pro rata rights, an investor would face **ownership dilution**

Uncommon in **Convertible Notes**:

Investor's ownership percentage has **not yet been established**

Later Stage Fundraising:

Pro rata rights granted to **earlier investors** be **waived** as a condition of funding

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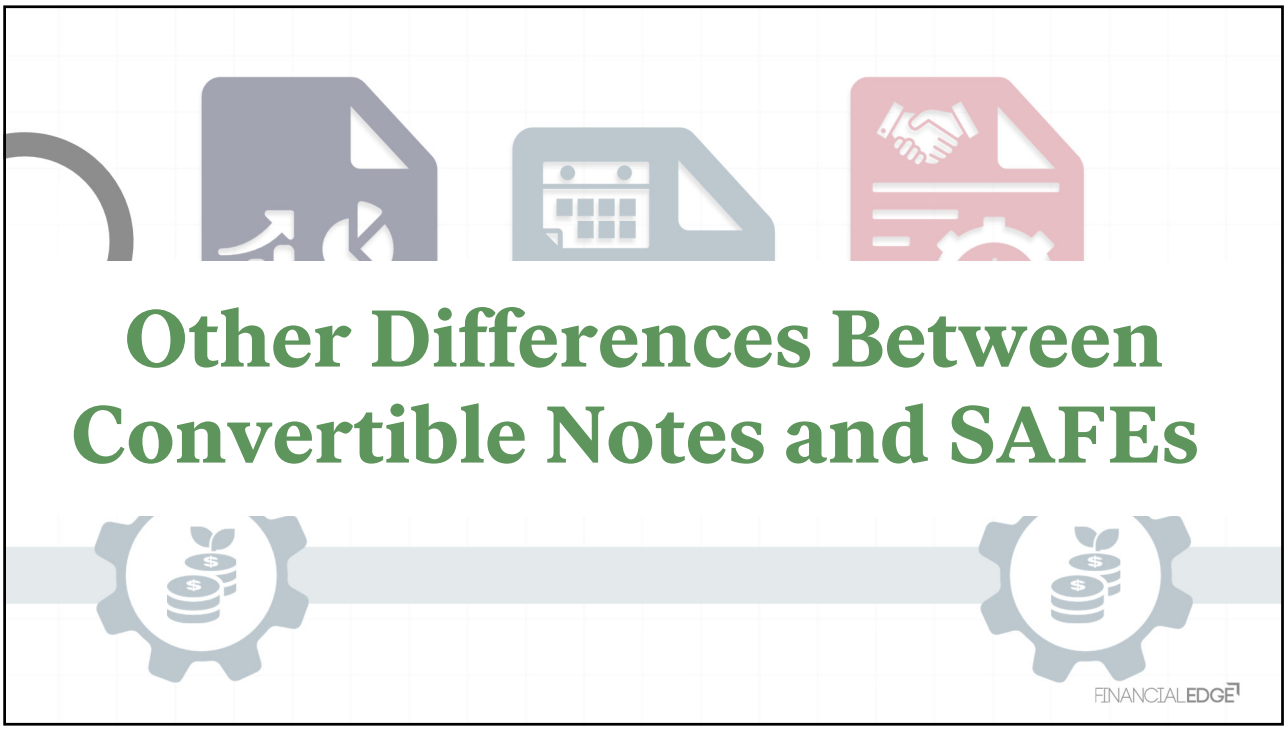

What Are The Differences?

	Convertible Note	SAFEs
Convertible security	Debt	Not debt
Interest bearing	Yes (interest converts along with principal)	No
Maturity date	Yes	No
Discounts	Yes	Yes
Valuation Caps	Yes; pre-money valuation cap	Yes; either pre- or post-money valuation caps
Most favored nation (MFN)	Not usually	Yes
Pro Rata Rights	Not usually	Yes
Payouts (Early Exits)	Yes	Yes
Conversion Thresholds	Yes	No

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Conversion Thresholds	Yes	No

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	Convertible Note	SAFEs
Payouts (Early Exits)	Yes	Yes

Convertible notes and **SAFEs** have provisions that address **"Payouts"**

Change in control

Investor has the **option** of **conversion** to **equity** at the **valuation cap** or a **1x payout**

Convertible note could lead to **bankruptcy**

SAFE notes in contrast, are **not loans**, and therefore do not have to be **repaid**

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Conversion Thresholds	Yes	No

SAFEs

Early-stage startups

Convertible Notes

Medical devices

Hardware

Biotech

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Found in Convertible Notes

States the **threshold or range** for converting the initial **debt component into equity**

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