VALUATION & FUND RAISING BY START-UPS

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What are Start-ups?

A Start-up is a new business venture providing services or products to an existing and growing market. A startup is in the first stage of operations and comprises one or more entrepreneurs. The primary aim is to respond to market demand by creating new and innovative products or services. While most small businesses might intend to stay small, a startup focuses on fast growth in a designated market. Usually, such companies start as an idea and gradually grow into a viable product, service, or platform.

Recent Developments

In 2016, the Government of India introduced the "Start-Up Scheme," its flagship initiative aimed at fostering innovation and promoting entrepreneurship to drive economic growth and employment opportunities throughout the country. This scheme provides various benefits to start-ups, including legal assistance, funding support, expedited processing of patent applications at reduced costs, and exemptions under the Income-tax Act, 1961.

As of April 30, 2022, the Start-Up Scheme has recognized 98,208 start-ups, with approximately 1,163 of them receiving income tax exemptions. Moreover, according to the data available on the Start-Up India website, more than 3,465 start-ups have been funded by the SIDBI Funds of funds. Currently, India boasts the world's third-largest start-up ecosystem, following the United States and China.

According to media reports as of December 2022, India had 108 start-ups with valuations exceeding $1 billion, thereby attaining the coveted "Unicorn" status.

Eligibility under Indian Laws

Ministry Of Commerce and Industry - Department for Promotion of Industry and Internal Trade

Under the Startup India Action Plan, startups that meet the definition as prescribed under G.S.R. notification 127 (E) are eligible to apply for recognition under the program.

Eligibility Criteria for Startup Recognition:

- The Startup should be incorporated as a private limited company or registered as a partnership firm or a limited liability partnership.
- Turnover should be less than INR 100 Crores in any of the previous financial years.
- An entity shall be considered as a startup up to 10 years from the date of its incorporation.
- The Startup should be working towards innovation/ improvement of existing products, services and processes and should have the potential to generate employment/ create wealth.
- An entity formed by splitting up or reconstruction of an existing business shall not be considered a "Startup."

https://www.startupindia.gov.in/content/dam/invest-india/Templates/public/198117.pdf

Companies Act, 2013

An entity is considered a "Startup" only if it is incorporated as a Private Limited company (under the Companies Act, 2013), or registered as a Partnership Firm (under the Partnership Act) or a Limited Liability partnership (under the Limited Liability Partnership Act) in India, and fulfils the following conditions:

- Not more than seven years have elapsed from its incorporation/ registration (for an entity in the biotechnology sector, this period is 10 years).
- The turnover of the entity in any financial year since incorporation/ registration has not exceeded INR 250 million.
- The entity is working towards innovation, development or improvement of products or processes or services, or is a scalable business model with a high potential of employment generation or wealth creation.
- Exemption is only available to Startups that are private companies or LLP formed on or after 01 April 2016.
- It holds a certificate of eligible business from Inter-Ministerial Board of Certification
- Plant and machinery used in the business should be new and have never been used in India before.

Income Tax Act, 1961

Post getting recognition a Startup may apply for Angel Tax Exemption. Eligibility Criteria for Tax Exemption under Section 56 of the Income Tax Act:

- The entity should be a DPIIT recognized Startup.
- The aggregate amount of paid-up share capital and share premium of the Startup after the proposed issue of share, if any, does not exceed INR 25 Crore.

https://www.startupindia.gov.in/content/sih/en/startupgov/startup_recognition_page.html

Types of Start-ups

1. **Scalable Start-ups**: Scalable start-ups primarily operate in the technology sector and strive for rapid growth and a high return on investment (ROI).

2. **Small Business Start-ups**: Small business start-ups prioritize longevity rather than scalability. While these businesses aim for growth, they do so at their own pace. Business owners typically rely on bootstrapping and self-financing for these start-ups.

3. **Social Entrepreneurship Start-ups**: Unlike other start-ups, social entrepreneurship start-ups focus on creating positive environmental and societal changes rather than generating wealth for the founders. Examples of such companies include charities and non-profit organizations.

4. **Large Company Start-ups**: Large company or offshoot start-ups are established by existing, well-established companies. These companies introduce revolutionary products and quickly gain recognition in the market.

5. **Lifestyle Start-ups:** Lifestyle start-ups are created by individuals who have a passion or hobby they wish to pursue. These business owners prioritize independence and invest their energy, money, and time in building a start-up around their favorite hobby or activity.

6. **Buyable Start-ups**: Buyable start-ups are unique in that their goal is not to become large and successful on their own. Instead, the business owner builds such a company from scratch with the intention of selling it to a larger corporation. These types of start-ups are commonly found in the technology and software industry.

Key Metrics of Start-ups

1. **Customer Acquisition Cost (CAC)**

   The customer acquisition cost (CAC) is a metric that provides an estimate of the total expenses incurred in acquiring a new customer. It typically encompasses various costs, such as advertising expenses, marketer salaries, salesperson costs, and other relevant expenditures. To calculate CAC, these costs are divided by the number of customers acquired within a specific period.

2. **Retention Rate**

   The customer retention rate is a key metric that indicates the percentage of customers a company is able to retain over a specific period of time. It is calculated by taking the number of customers at the end of a given period, subtracting the number of new customers acquired during that period, and then dividing it by the number of customers at the start of the period.

3. **Average order size**

   The average order size refers to the mean amount of money that customers spend when making a purchase from a business. This metric plays a crucial role in assessing the overall performance and profitability of a company. Monitoring the average order size is significant as it provides insights into the revenue generated per customer. If the average order size is relatively low, it may indicate that the business is not generating sufficient revenue from each customer.

4. **Monthly Recurring Revenue (MRR)**

   Monthly recurring revenue (MRR) represents the anticipated monthly revenue generated from customers. This metric holds significance as it enables businesses to track their growth and forecast future revenue. By analyzing MRR, companies can gauge their financial performance on a recurring basis and make informed projections regarding their revenue streams.

5. **Annual Run Rate (ARR):**

   The annual run rate represents the projected annual revenue generated from customers. This metric is valuable for tracking business growth and predicting future revenue.

6. **Cash Runway:**

   Cash runway refers to the duration a startup has before depleting its available funds and achieving profitability. This metric is crucial for monitoring progress and ensuring that the startup stays on track towards profitability.

7. **Burn Rate:**

   Burn rate measures the rate at which a startup utilizes its funds. It is an important metric for tracking progress and ensuring that the startup is on a path towards profitability.

8. K-factor:

The K-factor reflects the organic growth rate of a startup through word-of-mouth and viral mechanisms. This metric is significant for tracking progress and ensuring sustainable growth towards profitability.

9. Monthly Active Users (MAU):

Monthly active users represent the number of individuals who engage with a product or service on a monthly basis. This metric is essential for tracking progress and ensuring steady growth towards profitability.

10. Return on Advertising Spend (RoAS):

For startups with advertising budgets, calculating the return on advertising spend is crucial. RoAS measures the effectiveness of advertising campaigns by dividing the sales generated from advertising expenditures over a specific period of time.

Valuation Methodologies

A. The Berkus Method

The Berkus approach, developed by Dave Berkus, an American venture capitalist and angel investor, offers a framework for valuing startups based on the evaluation of five key success factors:

- Basic Value: This factor assesses the core value proposition of the startup.
- Technology: Evaluation of the uniqueness and potential of the technology employed.
- Execution: Analysis of the startup's ability to execute its business plan.
- Strategic Relationships in the Core Market: Assessment of partnerships and relationships in the target market.
- Production and Consequent Sales: Examination of the production capabilities and projected sales.

The Berkus approach involves assigning monetary values to each of these success factors and summing them up to determine the startup's valuation. This approach typically allocates a maximum of $500,000 per success factor, resulting in a theoretical maximum pre-money valuation of $2.5 million. While this approach does not consider other market factors, its limited scope can be beneficial for businesses seeking a straightforward valuation tool.

The Berkus approach is sometimes referred to as the stage development method or the development stage valuation approach.

B. Comparable Transactions Method

The Comparable Transactions Method is a widely used startup valuation technique that relies on precedent and seeks to answer the question, "What were similar startups acquired for?"

When using this method, it is important to consider ratios or multipliers to account for significant differences between the two businesses being compared. For instance, if another SaaS company possesses proprietary technology while your business does not, it may be appropriate to apply a lower-end multiplier from the range. This method shares similarities with the Market Multiples Approach.

C. Scorecard Valuation Method

The Scorecard Method is an alternative approach suitable for pre-revenue businesses. It involves comparing the subject startup to other funded companies while considering additional criteria.
Strength of the team0-30%Size of the opportunity0-25%Product or service0-15%Competitive environment0-10%Marketing, sales channels, and partnerships0-10%Need for additional investment0-5%Other0-5%
To apply the Scorecard Method, follow these steps:

- Determine the average pre-money valuation of comparable companies.
- Evaluate how your business compares to these companies based on various qualities.
- Assign a comparison percentage to each quality. This percentage represents how your business measures up to competitors - whether it is on par (100%), below average (<100%), or above average (>100%) for each quality.
- Calculate a factor for each quality by multiplying the assigned percentage by the weight of that quality (e.g., 30%).
- Sum up all the factors calculated in the previous step.
- Multiply the sum of factors by the average valuation in your business sector to determine your pre-revenue valuation.

By following this process, the Scorecard Method allows for a comprehensive assessment of the startup's qualities and provides a valuation estimation for pre-revenue businesses.

D. Cost-to-Duplicate Approach

The cost-to-duplicate approach involves considering all costs and expenses associated with a startup and the development of its product, including the acquisition of physical assets. By accounting for these expenses, the approach aims to determine the fair market value of the startup.

However, the cost-to-duplicate approach has several drawbacks:

- Neglecting future potential: This approach does not take into account the startup's future potential by projecting financial statements that reflect its anticipated sales and growth.
- Ignoring intangible assets: The approach fails to consider intangible assets alongside physical assets. Even at the startup stage, a company may possess valuable intangibles such as brand value, goodwill, patent rights (if applicable), and other intellectual property rights that can significantly impact its valuation.

By overlooking these aspects, the cost-to-duplicate approach may not provide a comprehensive valuation that accounts for the startup's true worth and growth potential.

E. Risk Factor Summation Method

The risk factor summation approach is a valuation method that considers the quantitative impact of various risks associated with a startup on the potential return on investment.

The process involves the following steps:

- Calculate an estimated initial value for the startup using any of the other valuation methods discussed.
- Assess the effect of different types of business risks on the initial value. Each risk is evaluated to determine whether it has a positive or negative impact, and an estimate is either subtracted from or added to the initial value accordingly.
- Consider all identified risks and apply the "risk factor summation" to the initial estimated value of the startup.
- Determine the final value of the startup after factoring in all the identified risks.

By incorporating risk assessment and adjusting the initial value accordingly, the risk factor summation approach provides a more comprehensive valuation that accounts for the potential risks and their impact on the startup's value.

The 12 common risk categories are as follows:

1. Management
2. Stage of the business
3. Legislation/political risk
4. Manufacturing risk
5. Sales and marketing risk
6. Funding/capital raising risk
7. Competition risk
8. Technology risk
9. Litigation risk
10. International risk
11. Reputation risk
12. Potential lucrative exit

F. Discounted Cash Flow Method

- The discounted cash flow (DCF) method focuses on projecting the startup's future free cash flow.
- A rate of return on investment, called the discount rate, is then estimated.
- Since startups are new companies and there is a high risk associated with investing in them, a high discount rate is generally applied.
- The future free cash flows are then discounted back to present value.

G. Venture Capital Method

As the name suggests, this method is a go-to for venture capital firms, and it's another option to consider if you need a pre-revenue valuation. It also reflects the mindset of investors who are looking to exit a business within several years.

There are two formulas to work toward the valuation:

- Anticipated Return on Investment (ROI) = Terminal Value ÷ Post-Money Valuation
- Post-Money Valuation = Terminal Value ÷ Anticipated ROI

First, you'll calculate your startup's terminal value, or the expected selling price after the VC firm has invested. You can find this using estimated revenue multiples for your industry or the price-to-earnings ratio.

Determine the anticipated ROI, such as 10x, and plug everything in to find your post-money valuation. From there, subtract the investment amount you're asking for to get your pre-money valuation.

Conclusion

As previously mentioned, there are various methodologies available for valuing start-ups. Different methodologies may be more suitable for specific types of start-ups. It's important to note that valuation is not an exact science, and there is no definitive right or wrong method. The choice of valuation method depends on the specific facts and circumstances of each case, such as the nature of the business, the stage of the start-up, the availability of comparable listed peers, and recent market transactions in similar sectors. Evaluating these factors can help determine the most appropriate valuation method to use.

FUND RAISING BY START-UPS

Why Start-ups need Funding?

A startup might require funding for one, a few, or all of the following purposes. It is important that an entrepreneur is clear about why they are raising funds. Founders should have a detailed financial and business plan before they approach investors. Start-ups usually require funding for the following activities –

- Prototype Creation
- Product Development
- Team Hiring
- Working Capital
- Legal and Consulting Services
- Raw Material and Equipment
- Licenses and Certifications
- Marketing and Sales
- Offices spaces and Admin expenses

Sources of Fund Raising

1. **Personal Investment/Bootstrapping**

   Personal investment or bootstrapping involves using your own money or assets as collateral to fund your business. This demonstrates your long-term commitment to the project to potential investors or bankers.

2. Friends and Family

Friends and family can be a valuable source of funding as they often trust and are more easily convinced compared to strangers. However, there is a risk of losing their money, and it's important to consider the potential impact on your relationship if that happens.

3. Venture Capital

Venture capitalists invest in companies by taking an equity position, typically supporting high-risk but promising projects. This involves giving up some ownership or equity in your business to an external party. Venture capitalists expect a healthy return on their investment, often achieved when the business sells shares to the public.

4. Angel Investors

Angel investors are affluent individuals interested in investing in promising startups. They have played a significant role in the early growth stages of many successful companies such as Alibaba and Google. In addition to providing capital, angel investors often offer mentorship to young entrepreneurs.

5. Crowdfunding

Crowdfunding involves raising funds by receiving loans, contributions, pre-orders, or investments from multiple individuals through a crowdfunding platform. It requires presenting a detailed description of your business to attract potential investors.

6. Business Incubators

Business incubators and accelerator programs support numerous startups in gaining market traction. These programs are particularly beneficial for startups in their early stages. While incubators and accelerators offer similar services, accelerators assist startups in achieving significant advancements in their business goals.

7. Grants and Subsidies

Governments actively seek to support new ideas and young entrepreneurs by providing grants, subsidies, and loans. Startups can also apply for awards and donations from government agencies. Initiatives like the "Startup India" and "Make in India" campaigns in India further contribute to government efforts in assisting startups.

8. Loans

Banks offer favorable financing terms and capital to businesses, particularly small and medium-sized enterprises. To secure a loan, a well-structured startup business plan is essential, outlining the business model, profit forecast, and expected maturity date. Banks provide two types of financial services: working capital loans and funding options.

Stages of Start-up

1. Pre-Seed/Ideation Stage

In the initial stage of the startup lifecycle, entrepreneurs have an idea and are focused on bringing it to life. Typically, they require a small amount of funds. At this early stage, fundraising options are limited and often informal. This phase involves conducting research and answering important questions, such as:

- Is the idea viable?
- Has the idea been previously executed?
- What are the estimated costs of the venture?
- What business model will be adopted?
- How can the startup get started?

These questions help lay the foundation for the startup and guide decision-making during the pre-seed stage.

Following are the available sources of funding at this stage –

- Bootstrapping/Self-financing
- Friends & Family
- Business Plan/Pitching Events

2. Seed/Validation Stage

During this stage, the startup has developed a prototype and aims to validate the potential demand for its product or service. This involves conducting a 'Proof of Concept (POC)' before proceeding to a full market launch. At this point, the startup has evolved from an idea to an actual business with some customer traction. To support its growth, entrepreneurs seek seed funding from investors, offering company equity in return for larger amounts of capital. Seed funding typically covers the following costs:

- Product launch
- Product marketing
- Hiring new employees
- Conducting market research to identify product-market fit

These activities are crucial for establishing a strong foundation and expanding the startup's presence in the market.

Following are the available sources of funding at this stage –

- Incubators
- Government Loan Schemes
- Angel Investors
- Crowdfunding

3. Series A/Early Traction Stage

During the Early Traction stage, a startup successfully launched its products or services in the market. Key performance indicators such as customer base, revenue, and app downloads become crucial in measuring progress. At this stage, the startup may seek Series A funding, which involves attracting investment from venture capitalists in exchange for shares of the company. This funding marks a significant milestone and sets the stage for future business growth. To leverage this opportunity, the startup focuses on the following aspects:

- Optimizing the business operations and processes to enhance efficiency and effectiveness.
- Mitigating any financial losses or shortfalls by strategically managing resources and cash flow.
- Further developing and refining the product or service based on customer feedback and market demands.
- Creating a scalable blueprint or strategy for future growth, ensuring that the business is prepared to expand and capture a larger market share.

These steps are essential for positioning the startup for long-term success and sustainable growth in the competitive market landscape.

Following are the available sources of funding at this stage –

- Venture Capital Funds
- Banks/Non-Banking Financial Companies (NBFCs)
- Venture Debt Funds

4. Scaling Stages

At this stage, the startup is experiencing a fast rate of market growth and increasing revenues. Startups in this stage have dedicated user bases and steady streams of revenue.

a) <u>Series B Funding</u>

At this point, you've proven you can scale your idea. Investors can now help you -

✓ Employ advanced market reach activities
✓ increase market share
✓ Form operational teams such as business development and marketing.

b) <u>Series C Funding</u>

Series C funding is for a company well on its growth path and often interested in expanding globally. It may be easier to find investors at this stage, as they trust the startup to succeed. Funds at this phase are used to do the following:

✓ Build new products
✓ Reach new markets
✓ Acquire underperforming startups in the same industry

c) <u>Series D Funding & beyond</u>

There is no limit to how many funding rounds a startup can go through. If a company has more advanced revenue goals, it may complete as many fundraising series as necessary. There are usually two reasons a startup goes past the Series C funding round. They are:

✓ **New opportunities**: A potentially lucrative opportunity appears that requires the company to act before the Initial Public Offering (IPO).

✓ **Subpar performance**: The startup misses the goals set during the Series C round of funding. It then raises more funds in the Series D round to address the issues.

Following are the available sources of funding at each of the stages –

- Venture Capital Funds
- Private Equity/Investment Firms

5. Exit Options

- **Mergers & Acquisitions**: In this scenario, the investor may decide to sell the portfolio company to another company in the market. This can involve the acquisition or merger of one company with another, either in whole or in part.

- **Initial Public Offering (IPO):** An IPO occurs when a startup goes public and lists its shares on the stock market for the first time. This process is typically undertaken by startups with a strong track record of profits and steady growth, as it involves complex legal and regulatory requirements.

- **Selling Shares:** Investors have the option to sell their equity or shares to other venture capital or private equity firms. This allows them to exit their investment and realize their returns.

- **Buybacks**: In some cases, founders of the startup may choose to buy back shares from the fund or investors. This can occur if the founders have sufficient liquid assets and desire to regain control of their company.

These various exit strategies provide opportunities for investors to monetize their investments in startups and for founders to transition to new phases or regain control of their ventures. The specific exit strategy chosen depends on factors such as the company's growth, market conditions, and the goals and preferences of the stakeholders involved.

Steps to Startup Fund Raising

1. Assessing the need for Funding:

The startup should carefully assess the reasons for requiring funding and determine the appropriate amount to be raised. Developing a milestone-based plan with clear timelines for the next 2, 4, and 10 years is crucial. This includes creating a financial forecast that considers projected sales data, market trends, and economic indicators. Costs associated with production, prototype development, research, and manufacturing should be thoroughly planned. Based on this analysis, the startup can determine the requirements for the next round of investment.

2. Assessing Investment Readiness:

Apart from identifying the funding requirement, it is important to evaluate the readiness of the startup to raise funds. Investors are interested in revenue growth, market position, favorable return on investment, time to break-even, profitability, uniqueness of the startup, competitive advantage, and the vision and future plans of the entrepreneurs. A reliable, passionate, and talented team is also essential to attract investors.

3. Preparation of Pitch Deck:

A pitch deck is a comprehensive presentation that outlines all the important aspects of the startup. It should tell a compelling story and flow logically from one element to another. The pitch deck is an opportunity to showcase the startup's value proposition, market potential, business model, competitive advantage, and financial projections.

4. **Investor Targeting:**

   Researching and targeting the right set of investors is crucial. Understanding the investment thesis of venture capital firms is important, as it identifies their investment strategy, focus areas, geographic preferences, and differentiating factors. By studying their past investments and engaging with successful entrepreneurs who have raised equity funding, startups can identify active investors, sector preferences, geographic locations, average ticket sizes, and the level of engagement and mentorship provided.

5. **Due Diligence by Interested Investors:**

   Interested investors, such as angel networks and venture capital firms, conduct thorough due diligence on the startup before finalizing any equity deal. This involves examining the startup's financial decisions, team credentials, and backgrounds to verify claims regarding growth and market performance. Successful completion of due diligence leads to finalizing the funding agreement on mutually agreeable terms.

6. **Term Sheet:**

   A term sheet is a non-binding document that outlines the major terms and conditions of the investment deal between the venture capital firm or investor and the startup. It covers important aspects such as valuation, investment structure (equity, debt, or a combination), management structure (board of directors and appointment/removal procedures), and changes to the share capital. The term sheet provides a framework for subsequent rounds of funding and addresses stakeholders' rights and obligations related to changes in the company's share capital.

Instruments for Funding

Equity Shares

Equity shares are long-term financing sources for companies. These shares are offered to the general public and cannot be redeemed. Investors who hold equity shares have voting rights, can share in the company's profits, and have a claim on its assets. The value of equity shares can be expressed in terms such as par value, face value, and book value.

Share Warrants

A share warrant is a contract that allows individuals to trade company shares at a fixed price on or before a predetermined date. The fixed price is called the "strike price," and the date before which the shares can be traded is the "expiration date." Share warrants are often offered at a price lower than the current market value. However, the shares are not issued when the warrant is presented. Instead, the warrant represents a promise to honor the strike price when the investor exercises their call rights. The investor must exercise the call right before the strike date for the company to fulfill the contract.

Preference Shares

Preference shares, also known as preferred shares, combine characteristics of both common shares and fixed-income securities. Holders of preference shares typically have priority when it comes to receiving dividends from the company. However, preference shares may not have the same level of voting rights or potential for capital appreciation as common shares.

- **Redeemable Preferences Shares**

  Redeemable preference shares are a type of preference shares that can be repurchased by the company at a later date. They provide a way for companies to return cash to existing shareholders and differ from traditional share repurchases in certain aspects. The repurchase price for these shares is predetermined at the time of issuance.

- **Convertible Preference Shares**

  Convertible preference shares allow holders to convert them into equity shares at a fixed rate. Conversion is typically allowed after a specified period and within a given time frame stated in the memorandum. Convertible preference shares can be optionally convertible or compulsorily convertible. They provide investors with the opportunity to receive preferred share dividends while also participating in the price change of equity shares.

  - **Compulsorily Convertible Preference Shares (CCPS)**

    CCPS is a popular instrument used by startups to raise capital. These preferred shares pay dividends and are compulsorily converted into common equity shares at a predetermined conversion ratio after a specific period. Once converted, the shareholders give up their preferred shareholder rights and become common shareholders, with voting rights and the ability to participate in share price appreciation.

  - **Optionally Convertible Preference Shares (OCPS)**

    OCPS is another tool used by startups to raise funds. Unlike CCPS, OCPS are optionally convertible into equity shares. The conversion is based on mutual agreement, with either the investor or the company having the option to convert the preference shares into equity shares. The option holder can exercise their right to convert before the expiry of the tenure. If the option is not exercised, the company will redeem the preference shares.

Debentures

A debenture is a type of long-term loan that corporations or governments obtain from the public to meet their capital requirements. Debenture holders act as creditors of the issuing company, unlike shareholders who are owners of the company. Similar to bondholders, debenture holders earn interest income for investing in the debt instrument. The interest rates, also known as coupon rates, are typically fixed unless they are of the floating type. Fixed interest rates provide stability and protect against market fluctuations, reducing investment risk. Debentures, like preference shares, can be either redeemable or convertible. Convertible debentures can further be classified as optionally convertible or compulsorily convertible.

Convertible Notes

What are Convertible Notes?

- Convertible notes are a form of short-term debt that can be converted into equity.
- In seed financing, these notes typically convert into shares when a Series A round of financing is closed. Instead of receiving their invested amount with interest, investors receive shares as part of the startup's initial preferred stock financing, based on the terms specified in the note.

What is the need for Convertible Notes?

The need for convertible notes arises when it is challenging to determine the valuation of a startup, especially in its early stages. Traditional fundraising rounds rely on a valuation to determine equity distribution, but for new businesses, this may be difficult to ascertain. Convertible notes address this issue by introducing the concept of "convertible equity." They can be issued during the pre-seed or seed funding stage and later converted into equity once the company has a valuation, typically during Series A fundraising.

Critical Terms of Convertible Notes

There are several critical terms associated with convertible notes:

- Interest rate: Convertible notes operate as debt instruments and carry an attached interest rate. However, instead of cash, the interest is paid in the form of equity in the business.
- Discount rate: Investors providing funding through convertible notes receive a discount when purchasing shares in the future.
- Valuation cap: To reward investors for assuming risk, a valuation cap is set as an upper limit on the company's valuation when the convertible note converts into equity.
- Maturity date: The maturity date signifies the final deadline by which the business is required to repay the loan or extend the agreement.

SAFE notes

What are SAFE Notes?

SAFE (Simple Agreement for Future Equity) notes, introduced in 2013 by Y Combinator, offer a simplified alternative to convertible notes. These notes allow startups to structure seed investments without involving interest rates or maturity dates. Typically, SAFEs are concise five-page documents, with the only negotiable detail being the valuation caps. In India, a similar instrument known as the 'iSAFE note' has gained popularity.

A Simple Agreement for Future Equity (SAFE) is a financing agreement between a company and an investor. It grants the investor the right to receive shares in the future, based on the company's valuation at a specified point in time, often the next funding round, typically the series A round.

Unlike traditional convertible notes, SAFEs are not considered debt but rather a form of convertible security. Therefore, they do not accrue interest and do not have a maturity date by which they need to be repaid. SAFEs can remain in effect indefinitely, and investors do not have any control or influence over the company's operations during that period.

To adhere to Indian legal requirements, the iSAFE note is structured as compulsorily convertible preference shares (CCPS), which means it is convertible upon the occurrence of specified events.

Benefits of SAFE notes include:

- **Simplicity**: SAFE notes are simpler compared to convertible notes. They do not have an end date or accrue interest, and they are typically concise five-page documents. Understanding and drafting a SAFE note may be possible without the need for legal assistance. The terms are straightforward, with clear advantages and disadvantages.
- **Reduced negotiation**: Unlike other investment instruments, SAFE notes involve less negotiation. The primary point of discussion may revolve around valuation caps, but other terms are generally standardized.
- **Provision for important events**: SAFE notes still include provisions for events such as early exits, change of control, or company dissolution. They offer benefits to investors, such as discounts and valuation caps, ensuring investor protection.

- **Conversion to equity**: Investors have the option to convert their investment into equity at a later stage. The timing of conversion is not predetermined but typically occurs when the startup raises an equity round and distributes preferred shares.

- **Flexibility for startups**: The absence of predefined terms and a maturity date provides startups with flexibility and freedom. There are no specific obligations or expectations associated with SAFE notes, allowing startups to navigate their growth trajectory without constraints.

- **Proportional benefits**: When SAFE notes convert to equity, investors may be entitled to proportional benefits based on their original investment. This may include receiving preferred stock, commonly known as "shadow" or "sub-series" stock. While this can offer advantages, it can also introduce complexity in the share structure. Startups should be mindful of potential legal costs during equity rounds.

Types of SAFE Notes

There are various types of SAFE Notes that can be issued by a startup to investors. Some of the SAFE notes used in transactions are discussed below:

- **Fixed Conversion at a future date:**

  The investor invests a particular sum of money and the company commits a particular percentage of equity to the investor.

- **Valuation Cap, no discount**:

  In these types of SAFE notes, there is an upper limit on the valuation of the firm in the next round but there is no floor cap and no discount is offered to the investors. The higher the valuation cap, the better it is for the founders as it will result in lower dilution of equity for the founder but provided founders are confident to close the next round at higher than the valuation cap.

- **Discount, no valuation cap:**

  In these SAFE notes, the investor only negotiates the discount for the next round and leave the valuation discussion for the future as that is discussed in pricing round.

- **Valuation cap and discount:**

  In this type, the investor agrees on both the discount and the valuation. Here, the discount is applied to the pre-money cap of the pricing round.

- **Most Favoured Nation (“MFN”) clause:**

  Here, the MFN clause entitles the investors to the same terms as offered to the subsequent investors, so that they will always get the most favourable terms.

Key Terms in a Shareholders Agreement

Pre-emptive Rights and Anti-dilution

Pre-emptive rights are provisions that require a company to offer new shares to existing shareholders in proportion to their current shareholding. This clause is effective when all existing shareholders are interested in making further investments. On the other hand, an anti-dilution clause plays a crucial role when a company offers new shares to new investors. It allows existing investors to maintain their ownership percentage without the need for additional investment.

Right of First Refusal (ROFR)

The right of first refusal is a protective clause that limits the transfer of shares. It ensures that control of the company is not transferred to undesirable third parties. If a shareholder intends to sell their shares, they must first offer them to existing shareholders at the same price. If an existing shareholder declines to purchase the shares at that price, the company may seek alternative investors.

Right of First Offer (ROFO)

A right of first offer grants non-selling shareholders the opportunity to make an offer for the shares being sold before the selling shareholder can solicit offers from third parties.

Tag-Along Rights

Tag-along rights protect the interests of minority shareholders when a majority of shareholders intend to sell their shares. Also known as piggyback rights, this provision allows minority shareholders to sell their shares at the same price and under the same terms if they choose to do so.

Drag-Along Rights

Drag-along rights, on the other hand, favor the buyer. They compel minority shareholders to sell their shares as part of a company sale, ensuring that the buyer can acquire 100% of the shares under the same price and terms.

Buy-out Rights

The shareholders' agreement should include a buy-out rights clause that specifies the circumstances under which the company or existing shareholders can purchase the shares of a shareholder who becomes incompetent due to events such as death, disability, bankruptcy, or marital dissolution. The agreement may also include an "expulsion" clause, which allows existing shareholders to expel undesirable shareholders and acquire their shares.

Exit or Termination Clause

An exit or termination clause outlines the process and terms for investors or founders to exit the business upon achieving predetermined milestones. This clause provides clarity on how investors or founders can exit, often through a fair valuation or with a guaranteed premium in the event of an acquisition.

Good Leaver Bad Leaver

The good leaver bad leaver clauses define the terms and value at which a departing shareholder's shares are sold. A good leaver typically refers to directors or employees who cease employment due to reasons such as redundancy, ill health, resignation, or seeking new job opportunities. A bad leaver, on the other hand, refers to an employee who departs on negative terms, such as breaching their employment contract or engaging in gross misconduct within a defined period. A good leaver may have the option, but not the obligation, to sell their shares upon departure. However, a bad leaver is required to sell their shares to other shareholders at the nominal value.