

# Capitalisation Table Part I: Understanding the Basics

Private Capital Insights



**Summary:** The cap table is a key document to stakeholders in the startup ecosystem. It documents both present and contingent equity holders, signaling the key data that enables players to make informed decisions. Crucial to understanding the cap table is having a grasp of the building blocks: ownership, valuation, dilution and liquidation preferences. This article explains each of these four building blocks in turn.

## 1. INTRODUCTION

Cap table (*‘capitalisation table’*) is a key feature in the startup ecosystem. At the most basic level, the cap table is framed as a document that reflects ownership stake in the startup. But the cap table goes beyond documenting ownership in a startup, and the practical reality is that a good cap table must:

- accurately track all transactions that **results** or may **potentially** lead to an ownership stake in the company;
- spell out various classes of shares and the accompanying rights; and the respective percentage ownership in the company,
- be ‘modellable’. That is, an investor should be able to model various exit scenarios through the information contained in the cap table.

This is the first of a two-part series, where we cover the building blocks: ownership, valuation, dilution and liquidation preferences. The edition that follows works through a case study from incorporation, seed/series investment and exit.

## 2. OWNERSHIP

Everything on a cap table reflects ownership stake in the company. This ownership could either take the form of Shares or Contingent Equity.

Throughout Part I & II, we use Delta Health Limited, a fictional Nigerian healthtech startup, as a running example to explain the point. The founders are Ade (CEO) and Bala (CTO). Their first institutional investor is Alpha Capital.

## A. Shares:

A share is a unit of ownership in a company, representing a proportionate stake in its equity capital. Nigerian law empowers companies to create different classes of shares, with each class carrying distinct rights and obligations. Two classes of shares dominate the cap table:

- i. **Ordinary Shares:** It has long been established that shareholders are typically entitled to at least three rights:
  - profit rights: entitlement to dividends when declared;
  - governance rights: right to partake in the governance of a company through attending and voting at company meetings; and
  - capital right: right to pro rata return of capital on liquidation, sale or merger (in any event, consistent with the liquidation waterfall under Section 657 of CAMA 2020).

Therefore, ordinary shares carry these basic rights without more. At incorporation, founders get ordinary shares. Employees, Advisers etc are also offered ordinary shares in the company.

At incorporation of Delta Health, Ade and Bala each receive 500,000 ordinary shares at ₦1 par value. Total issued share capital: 1,000,000 ordinary shares. Ade: 50%. Bala: 50%.

- ii. **Preference Shares:** Unlike ordinary share, the key feature of preference share is that it modifies any or all the three classical rights of shareholders. So, a right to receive dividends *when declared* may be modified to right to receive dividend at 8% annually,

whether declared or not; or a right to participate in capital return pro rata in the event of liquidation may be modified to a right of the preference share class being paid ahead of the ordinary shareholders. Preference shares is typically offered to investors of the startups such as angel or series investors.

## B. Contingent Equity:

Contingent equity refers to instruments that do not represent shares at the *date of issue* but which may, upon the occurrence of agreed trigger events, result in the holder receiving shares in the *future*. Within the broad spectrum of contingent equity prevalent in startups are:

- i. **Convertible Notes:** This is a debt contract. The investor lends the startup an amount (principal), at an agreed interest rate, repayable by a fixed maturity date. Instead of demanding repayment in cash, convertible notes give the investor the right to convert the debt obligations (i.e., principal and accrued interest) into preference shares in the startup.

Delta Health needs \$200,000 to reach its Series A. Alpha Capital agrees to lend \$200,000 for 12 months at 6% per annum. At the Series A, Alpha can convert the full \$212,000 (principal plus interest) into Series A Preference Shares.

- ii. **Simple Agreement for Future Equity (SAFE):** this is a novel convertible instrument introduced by Y combinator in 2013. Unlike a convertible note, a SAFE is not a debt contract. There is no principal, nor interest rate and maturity date. Rather, the investor hands over an agreed

amount in exchange for a contractual **right** to receive shares upon a trigger event, typically at the next priced equity round.

In the UK, the equivalent to SAFE is the Advance Subscription Agreement (ASA). The ASA operates on similar mechanics but is structured to qualify for SEIS/EIS tax relief, which is a material advantage for UK facing investors.

- iii. **Convertible Preference Shares:** This is preference shares with an option to convert into ordinary shares on agreed terms. ‘Why would an investor convert to Ordinary Shares?’, a curious observer may ask. The simple answer is to benefit from an upside. In the event of sale or IPO, ordinary shares may trade at a **premium** relative to the preference shares (please *see further discussion at liquidation preferences*).
- iv. **Options:** An option gives the holder the *right*, but not obligation, to purchase shares at a given price that is usually set at a price below the market value at the date of grant.

If Delta Health grants Bala, its lead engineer and CTO, an option to purchase 100,000 ordinary shares at £2 per share. Three years later, the company is valued at £50 per share. The engineer exercises the option, pays £200,000 and receives shares worth £5,000,000.

Options exist because early-stage startups are cash-constrained. In a market where competition to attract and retain top talent is fierce, startups are disadvantaged as they cannot pay market-rate salaries. Therefore, options solve this issue by offering future equity

upside in addition to existing compensation.

It is worth noting that investors routinely require founders to establish or expand the option pool as a condition of investment. An option pool is a block of shares that is reserved (but not yet granted) for future issuance to employees/management under an employee incentive scheme. Option pools also feature prominently in startups.

- v. **Warrants:** these are functionally long dated options, but offered to investors as a ‘sweetener’ to a deal. A warrant also gives the warrant holder the right, but not obligation to buy shares of the company (or related company) at a strike price, with the key difference from option being that it is transferrable to third parties.

### 3. VALUATION

Simply put, valuation is what a start-up is worth. Nothing more, nothing less. Experts have developed various models to arrive at a company’s worth, but in the context of funding rounds, two key figures are really important:

- I. **Pre-money Valuation:** This is the value of the company before external financing such as seed or series financing.
- II. **Post-money valuation:** This is the value of a startup post financing. It is mathematically represented as thus:

Post Money Valuation = Pre-money valuation  
+ New Investment Amount.

Pre-money valuation is really important for setting the entry price as it is the primary basis for deriving the price per share for new investment.

Alpha Capital agrees to invest \$2,000,000 at a post-money valuation of \$10,000,000. The pre-money valuation is \$8,000,000. Alpha's stake:  $\$2m \div \$10m = 20\%$ .

#### 4. DILUTION

This refers to the reduction of percentage ownership in a company as a result of the Company issuing new shares.

Recall that at incorporation, Delta Health has 1,000,000 shares outstanding. Both Ade and Bala hold 500,000 each, which represents 50% apiece of the startup. In a Seed Financing round, Alpha Capital receives 250,000 newly issued shares. Total outstanding share is: 1,200,000

Ade:  $500,000 \div 1,250,000 = 40\%$ . Bala:  $40\%$  (similar calculation). Alpha:  $250,000 \div 1,250,000 = 20\%$ . Effectively, each founder has been diluted by 10%.

As a rule of thumb, dilution and valuation are tied at the hip. That is, the lower the pre-money valuation, the more shares the company issues to investors to hit its target stake, and thereby further diluting the ordinary shareholders (founders & employees).

#### 5. LIQUIDATION PREFERENCES

As noted earlier, the capital right of a shareholder refers to the right to pro rata return of capital upon liquidation. A liquidation preference modifies this baseline by giving shareholders with liquidation preferences a priority right to receive distributions in a 'liquidation event'. In the startup context, a liquidation event is defined broadly not just to include formal winding up, but extends to

when your startup is acquired. It therefore follows that liquidation preference activates before the founders see a penny.

Alpha Capital invests \$2,000,000 in return for Seed Preference Shares with a 1x non-participating liquidation preference. This means that on a liquidation event, Alpha receives \$2,000,000 before any proceeds are distributed to ordinary shareholders (Ade and Bala). If we assume that Delta Health Ltd is sold for the below figures:

\$3m: Alpha takes \$2m. Founders split \$1m.

\$12m: Alpha takes \$2m. Founders split \$10m.

\$1.5m: Alpha takes \$1.5m (capped at proceeds). Founders get nothing.

Liquidation preferences may be participating or non-participating, with the key distinction being **entitlement** to partake in surplus in a liquidation event.

Put differently, an investor with a non-participating preference share may on a liquidation event, elect to pursue its preference or convert to ordinary shares, whichever favours him the most. In the example above, there is no incentive for Alpha Capital to convert at an exit of \$3m or \$1.5m. Reason? It'll earn his full return.

However, the incentive shifts at \$12m exit. 20% of the exit sum (i.e., \$12m) is \$2.4m which is higher than the preference. Therefore, Alpha would naturally abandon his preference and convert to ordinary shares to benefit from the 'upside'.

For participating liquidation preference, the holder gets his preference **plus** the upside. Please note that this is not market standard and sparingly used in relatively few circumstances.

#### 6. CONCLUSION.

The next newsletter will work through a case study.

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