April 2015

Capital Raising? 2014 Observable Trends for Seed and Early Stage Financings – AlleyWatch Reviewed Approximately 200 Capital Raising Companies

As counsel to scores of companies in capital raising mode at any point in time, my colleagues and I regularly are asked questions by entrepreneurs regarding the valuations and other terms they should expect to receive from investors. Because startups come from different industries with different approaches to solving different problems with different management teams and respond to the needs of different-sized markets requiring varying levels of capital intensity, certainly no one size fits all and there is no arithmetic or formulaic approach to specifically answer such questions. Even so, detailed examination of large numbers of deals reveals observable trends. AlleyWatch recently published findings from its review of roughly 200 capital raising companies, each of which raised $3 million or less in 2014. Its findings support what has been apparent anecdotally – Silicon Alley is increasingly hospitable to founders, and investors are agreeing to terms that are increasingly “founder friendly.” The findings also are instructive to founders hoping to glean key trends for their anticipated financing transactions.

According to AlleyWatch, many of the traditional early stage investors have become more like later stage venture investors, seeking and obtaining the kinds of rights, preferences, privileges and designations previously associated with professional and institutional investors. Even so, AlleyWatch says, terms in the past three years have become a lot more founder friendly. It points to several key factors. Nearly one-half of all seed investors participate in subsequent rounds. It also points out three key developments likely to enhance the availability and ease of seed investments:

- Y Combinator, renowned startup accelerator, has pioneered a new investment vehicle called SAFE (Simple Agreement for Future Equity), which is basically a security convertible in the next equity round, but which is not a debt instrument and is intended to be extremely simple to implement.[1]

- So-called party rounds, with an average of nine to 11 investors together, continue to grow in popularity.

- The crowdfunding platform AngelList encourages investor participation and reduces costs in multi-investor rounds with its syndication model (helping rally up investors and lower legal costs).

Observable Trends in 2014 Equity Terms

AlleyWatch’s review provides some important observable trends for 2014. For example, in 2014 overall median valuations continued to rise (although to a lesser extent than they did in 2013), from $6 million in 2012 to $7.2 million in 2013 and $7.5 million last year. The median number of dollars raised was $2 million. Almost every deal (92%) included investor representation on the board of directors, most often limited to one seat on the board (84%). While 95% of the deals surveyed included preemptive pro rata rights to participate in future investments, over one-half (58%) included a provision that limited such rights to raises in excess of $100,000. In light of the superior rights of a participating preferred stock structure, it is important to note that 97% of the capital raising transactions at this level did not have participating preferred rights. Virtually all deals, 99%, included a liquidation preference (1x). Anti-dilution protection in the event of subsequent down rounds was found in 85% of the transactions; 88% included rights of first refusal and co-sale rights. Drag-along rights also were almost ubiquitous, found in 82% of the raises. Every deal surveyed included other standard protective provisions.

Observable Trends in 2014 Convertible Note Financings

Convertible note financing transactions continue to be an important structure for seed-level and other early stage investments. The median capped conversion price increased to $7 million in 2014 from $6 million in the prior year. The dollar amount raised using this financing structure also increased to a median of $950,000, with one-half over $1 million, one-quarter between $500,000 and $1 million, and one-quarter under $500,000. Almost all of the deals surveyed (84%) had a term of between 12 and 24 months and two-thirds had an interest rate between 4% and 8%. A large majority (84%) included automatic conversion upon an acquisition; only a few made that conversion subject to the investor’s option. While 78% of the transactions did not incorporate a change-in-control premium, a relatively significant number (20%) included up to a 2x premium on a change in control. Over two-thirds (68%) permitted conversion, rather than repayment, upon maturity. Only one-quarter (25%) of the financings included preemptive pro rata investment rights in future rounds, and only 15% provided for most favored investor revisions if future financings are consummated on better terms. While warrant kickers used to be fairly common, convertible note financings rarely incorporate them today. Similarly, almost none of the deals offered investor veto rights on proposed sales of the company, provided for security interests for investors, or offered seats on the board.

Enter SAFEs?

AlleyWatch also reported on the introduction of SAFEs, the much-debated, controversy-stirring new instrument intended by its advocates to replace most convertible note financings. SAFE transactions in 2014, very few in number, typically were smaller than both equity and convertible note financings, raising roughly $500,000 per transaction at a median capped conversion price of $5 million and a 20% discount from the price in the subsequent equity round. While Y Combinator's proposed SAFE transactions would remain as simple as nothing more than a capped conversion price and a discount, some of the observed deals included pro rata preemptive rights and change-in-control premiums.

In an era of substantial, ongoing innovation, a decline in capital intensity for many startups empowered them to reach commercialization, positive cash flow and profitability far more quickly than ever before, and an abundant availability of seed and startup capital has incented, perhaps emboldened, entrepreneurs to pursue their passions, solve new problems, and start new companies. They are, therefore, eager to find those founder-friendly investors willing to provide favorable financing terms. The questions to ponder include whether this is a sustainable environment for entrepreneurs and investors or if the all-too-common retraction will soon occur. We all hope for the former, but plan for the latter.

David J. Sorin
Partner and Chair
Venture Capital and Emerging Companies Practice
732.867.9742
dsorin@mccarter.com

[1] See our Client Alert dated January 16, 2015 located at http://www.mccarter.com/Better-SAFE-Than-Sorry-A-New-Way-to-Finance-Start-ups-01-16-2015/, as well as results of an interview with David Sorin conducted by Metropolitan Counsel, http://www.mccarter.com/David-Sorin-interviewed-in-Better-SAFE-Than-Sorry-A-New-Way-to-Finance-Start-ups-which-appeared-in-Metropolitan-Corporate-Counsel-01-27-2015/.