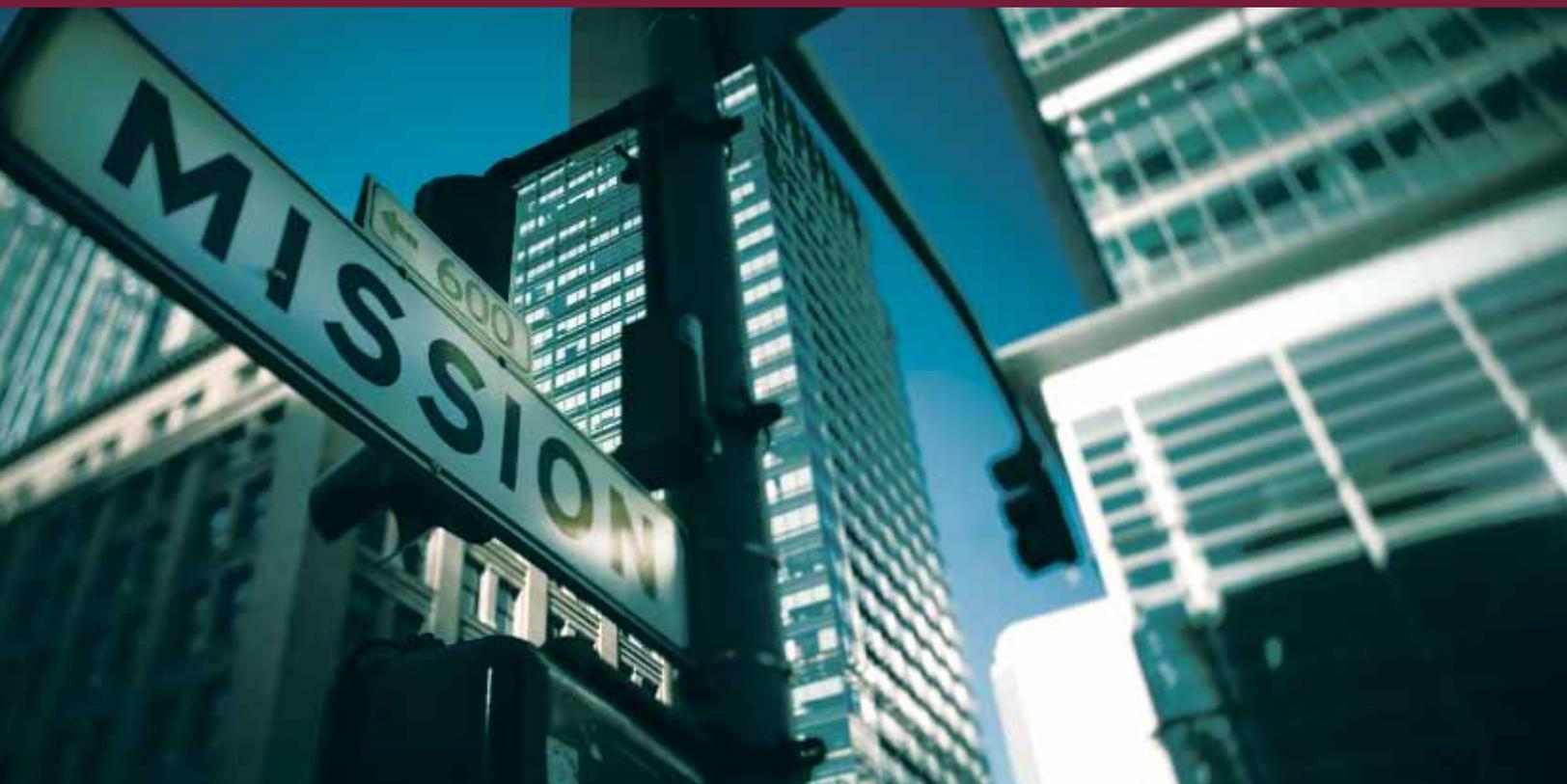




# SEED FINANCING REPORT

A comprehensive look at the very early stage  
venture capital financing market

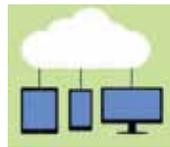
Q4 2014 through Q3 2015



# INTRODUCTION

## A Quick History Lesson.

A decade ago, entrepreneurs just getting their startup ideas off the ground were limited to financing their ventures either with their own money or by raising seed money from friends and family or high-net-worth individuals. Around 2005, more experienced, active and limited partner-backed “super angels” began making seed investments. These investors focused on very early stage companies and typically placed bets under \$3 million. In 2010, this very early stage venture capital financing market experienced a dramatic uptick, in large part because of the proliferation of angel investors and seed funds looking to invest in early stage companies and the willingness of traditional venture capital funds to get into the seed game.



At the same time, innovations like software and services in the cloud, cheap storage and crowdsourced labor have enabled founders to hit the ground running with significantly less capital than their counterparts from the late 1990's. New entrepreneurs are taking the plunge every day, all over the country (and really, all over the world). The challenges that these entrepreneurs face are incredibly unique. These founders are taking “bet the company” risks everyday as they hire their first employees, attempt to find and close commercial partners and raise capital. Resources are limited, competition is intense and decisions around how to structure early stage financings often have repercussions as the company scales. In our first report, “Seed Financing: Three Years in Startup Land” we looked at trends in the very early stage seed funding market from 2010 through 2012<sup>1</sup>. In examining nearly 300 deals over a three year period, our data revealed an interesting dichotomy: very founder favorable economic terms, combined with stronger attempts from investors to maintain negative control. Last year, in examining the very early stage seed funding market in 2013 and the first 3 quarters of 2014, our data indicated a continuation of these same trends, but also seed investors acting more like later stage institutional investors and demanding the right to participate alongside larger funds in later rounds and investing anew in startups with a few rounds under their belts<sup>2</sup>.

## Why Another Report?

Now that we are about a decade into the seed funding trend, the seed financing market has matured. Founders and Investors are more opinionated than ever about the market. The dust has settled and the market has had a genuine opportunity to process and understand the implications of various economic terms and deal structures. We have noticed several trends that evidence this maturation of the market and the heightened sophistication of its players.

“ We are once again aiming to **deliver the authoritative report, capturing not only the data, but also PERSPECTIVE AND ANALYSIS** ”

As with our prior endeavors, this report speaks to those on the very early end of the startup life cycle – and provides entrepreneurs and investors with a deeper look at the seed funding market. Other venture finance reports focus on later stage financings (Series A and beyond). Silicon Legal has been in a unique position in that over the past six years, we have emerged as an incredibly active firm (and without question the most active boutique firm) in this very early stage seed funding space. We are once again aiming to deliver the authoritative report, capturing not only the data, but also perspective and analysis.

# INTRODUCTION

## Methodology and a Reality Check.

This report analyzes seed financing trends from the fourth quarter of 2014 through the end of the third quarter of 2015. We examined 163 rounds of seed financing during that period for software and digital media/internet companies based in the San Francisco Bay Area, Los Angeles, Seattle and New York in which Silicon Legal represented the company or the investor(s). Note that for the purposes of this survey the definition of “seed” financing is limited to a company’s first round of note, equity or SAFE financing of up to \$4,000,000, (yes, those of us who have been doing this for a while marvel that \$4MM is now a “seed” round), or extensions of such seed rounds, that is led by a professional investor. By “professional investor” we mean (i) individuals who regularly invest their own funds in early stage companies, or (ii) funds that invest in the emerging companies.

As in our prior reports, the big challenge in interpreting this data is that while deal terms exhibit certain statistical trends, navigating the venture capital financing market is still more art than science (especially at the seed stage). There are countless examples of “outlier” transactions – and trying to put the specifics of a deal into perspective by looking at “comps” can be frustrating. The reality is that while a “market” is set for most financing deal terms, everything is negotiable. In a vibrant fundraising environment, sometimes it feels like “anything goes” if the deal is a hot one!

## Our Takeaway.

In our prior reports, we posited that while the economic terms of seed financing rounds were founder favorable, certain market forces were driving seed investors to seek additional control and strong down-side protection and to behave more and more like later stage institutional investors.

Over the last four quarters, while the trend lines on the economic and control terms have held steady, we are seeing founders and investors negotiate hard on various technical deal terms that impact their economic stake in the companies. Investors continue to demand pro rata rights and are starting to expect existing convertible securities to convert in the pre-money. Founders are pushing back (more successfully) on the liquidation preference overhang in convertible notes.

“founders and investors are increasingly **NEGOTIATING** TECHNICAL ECONOMIC TERMS”

# TRENDS AND DEVELOPMENTS

## Bigger Rounds; Round Extensions; More diligence.

The amount of capital raised in seed convertible note, SAFE and priced equity rounds has continued to increase as companies are deferring their Series A rounds for longer periods of time. Our survey data indicates that the average amount of capital raised in seed rounds has increased as follows in the last four quarters compared to the prior four quarters: 22% increase in the size of note rounds; 27% increase in the size of SAFE rounds, and 39% increase in the size of equity rounds.

Our data corroborates the observations of other commentators<sup>3</sup> that early stage companies are increasingly extending their seed rounds and raising additional capital from new investors without a significant increase in valuation cap or valuation, as applicable, if any. Our survey data indicates that in the last four quarters 23% of seed rounds included additional capital raises as part of extensions, while such extensions were a part of only 10% of seed rounds in the preceding four quarters. A few factors are driving this phenomenon:

- The bar required to raise a Series A round due to the much talked about “Series A Crunch” has remained high.
- But, there has been no downtick in the number of investors and amount of capital chasing seed deals.

What investors participating in these larger note rounds and extensions of seed equity rounds are asking in return is more due diligence. Investors who in the past only did cursory diligence on companies are now, even in convertible note and SAFE rounds, increasingly asking more pointed questions about performance metrics, prospects for future funding, financials, legal housekeeping, and intellectual property.

## Continued Emphasis on Pro Rata Rights.

We discussed the phenomenon of larger venture capital funds investing early and demanding preemptive or “pro rata” rights in seed rounds in our last report. These trends have persisted over the past four quarters – we have seen pro rata rights in 96% of equity rounds, 52% of convertible note rounds, and 90% of SAFE rounds. This was a particularly dramatic uptick for convertible note rounds, where investors are participating with side letters guaranteeing pro rata rights in more and more deals.

Ironically, the likelihood of investors getting less than their pro rata share in the Series A round increases as the company gives such rights to more and more investors. As more seed investors are granted pro rata rights, they end up having a contractual right to a significant portion of the Series A round. Because new investors typically expect to own a certain portion of the Series A round, founders often find themselves having to fight for the seed investors’ pro rata rights with the new money investors. Those investors who have secured contractual pro rata rights learn quickly that *relationships* with the founders are an equally critical component to protecting those rights.

# TRENDS AND DEVELOPMENTS

## Conversion of Notes and SAFEs in the Pre-Money.

Convertible notes are often silent as to whether or not they convert on a pre-money or post-money basis, and founders typically address the treatment of notes in conjunction with the negotiation over the valuation at the term sheet stage.

Founders' dilution hit is partly a function of how convertible securities are treated. As an example, if a company raised \$1,000,000 via convertible notes with a valuation cap of \$6,000,000 and subsequently raised \$8,000,000 in new capital in a Series A round at a pre-money valuation of \$20,000,000, the ownership stakes will break down as follows:

|                               | PRE-SERIES A |                | POST-SERIES A<br>(Notes NOT in Pre-Money) |                | POST-SERIES A<br>(Notes in Pre-Money) |                |
|-------------------------------|--------------|----------------|---|----------------|---------------------------------------|----------------|
|                               | Shares       | %Fully Diluted | Shares                                    | %Fully Diluted | Shares                                | %Fully Diluted |
| <b>FOUNDERS</b>               | 10,000,000   | 100%           | 10,000,000                                | 64%            | 10,000,000                            | 61%            |
| <b>NEW SERIES A INVESTORS</b> | –            | 0%             | 4,000,000                                 | 26%            | 4,666,667                             | 29%            |
| <b>NOTE/SAFE INVESTORS</b>    | –            | 0%             | 1,666,667                                 | 10%            | 1,666,667                             | 10%            |
|                               | 10,000,000   | 100%           | 15,666,667                                | 100%           | 16,333,334                            | 100%           |

As shown in the table above, including the notes in the pre-money results in more dilution of the founders' ownership stake.

There has been a change in the investors' view on this issue as investors are increasingly expecting any and all previously raised capital, whether raised via equity, convertible note or SAFE, to be included in the pre-money capitalization. As the size of note and SAFE rounds increases, it is becoming more important for founders to address this point as soon as there is any discussion about valuation with potential investors. As other commentators have noted, the simple solution is to agree to the post-money valuation, instead of the pre-money valuation<sup>4</sup>.

# TRENDS AND DEVELOPMENTS

## Hybrid Conversion of Notes.

Upon a subsequent priced-round financing, convertible promissory notes traditionally have provided for automatic conversion into shares of the same preferred stock issued to new money investors. If the company is successful in raising the next priced round at a valuation higher than the valuation cap of the convertible notes, the noteholders end up with a liquidation preference greater than the dollars actually invested. This “liquidation preference overhang” is effectively a multiple liquidation preference for the angel investors, which is not in line with the 1x preference most VC investors and founders agree to in venture financings.

As an example, if a company raises its Series A round at a pre-money valuation of \$10,000,000, resulting in a per share price for new money of \$4.00, and the Series A has a 1x liquidation preference, then outstanding notes in the principal amount of \$500,000 and with valuation cap of \$2,500,000 will get liquidation preference in the amount of \$2,000,000 (which is 4x the noteholder's investment amount).

The impact of the liquidation preference overhang becomes more significant as the size of note rounds increases and companies raise multiple note tranches, often resulting in an increase in the delta between pre-money valuation of Series A rounds and valuation cap of convertible notes.

**Leading voices in the startup community have put this issue on the founders' radar<sup>5</sup> and many investors are now agreeing to either:**

(i) Convert notes into a combination of preferred stock and common stock, such that the price discount resulting from the valuation cap is paid in common stock and the aggregate liquidation preference of the shares of preferred stock issued upon conversion of the notes equals the principal plus interest of the notes; or

(ii) Convert notes into “shadow preferred stock,” which is a series of stock that is exactly the same as the preferred stock issued to new money investors in all respects except for the liquidation preference and anti-dilution and dividend rights. The liquidation preference of such shadow preferred stock equals the principal plus interest of the notes, instead of the price per share paid by the new money investors. The SAFE securities popularized by Y Combinator incorporate this approach<sup>6</sup>.

**The result of both of these solutions is that noteholders' liquidation preference is equal to their investment amount.**

However, these solutions come with some downsides. The conversion to common stock may significantly impact the control that founders have over the company's outstanding common stock, which becomes relevant for purposes of calculating voting thresholds for future financings, recapitalizations, and acquisitions. In addition to adding a layer of complexity to the legal documents, the conversion to shadow preferred stock gives the former noteholders blocking rights under Delaware corporate law with respect to any amendment to the company's certificate of incorporation that would “alter or change the powers, preferences or special rights of the shares of such class so as to affect them adversely.” The result is that any recapitalization, for example, will require consent of the former noteholders, voting as a separate class, instead of voting as part of the same class as the new money investors.

**Founders issuing convertible notes should carefully weigh the benefits of eliminating the liquidation preference overhang with the voting rights implications of issuing common stock or shadow preferred stock.**

# DEAL TERMS HIGHLIGHTS

## Deal Term Highlights: Convertible Note Financings

**Our survey data shows a continuing increase in the size of convertible note rounds.**

- Amounts raised in convertible note rounds are on the rise – the median convertible note raise in the last four quarters was \$1,000,000, up from \$950,000 in the prior three quarters.
- Valuation caps for the convertible notes continue trending more favorably for companies. The median valuation cap for convertible notes in the last four quarters was \$7,500,000.
- The continuation of “party rounds” — where companies round up numerous investors to participate in financings – is again confirmed by our survey data. The median number of investors participating in note rounds was 13 in the last four quarters.
- 52% of notes rounds in the last four quarters included preemptive (pro rata) rights for investors.

## Deal Term Highlights: Equity Financings

**The terms for equity financing rounds have remained relatively stable and founder-friendly, while the size of such rounds is increasing.**

- Amounts raised in equity rounds are on the rise – the median equity raise in the last four quarters was \$2,700,000, up from \$2,000,000 in the prior three quarters.
- Pre-money valuations continue to increase — median in the last four quarters was \$8,300,000.
- From a control perspective, investors are taking board seats more often. In the last four quarters, investors took board seats in 93% of equity seed rounds.
- Investors got preemptive (pro rata) rights in 96% of seed equity deals in the last four quarters.

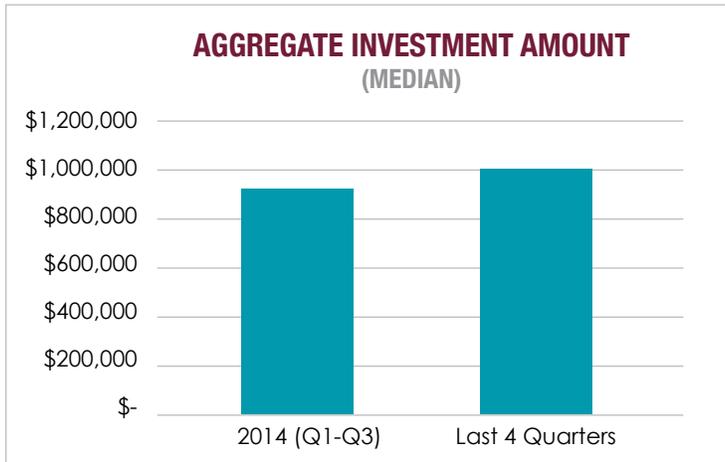
## Deal Term Highlights: SAFE Financings

**The terms for SAFE financing rounds show similar trends as the note and equity rounds – size of rounds is larger and valuation caps are higher.**

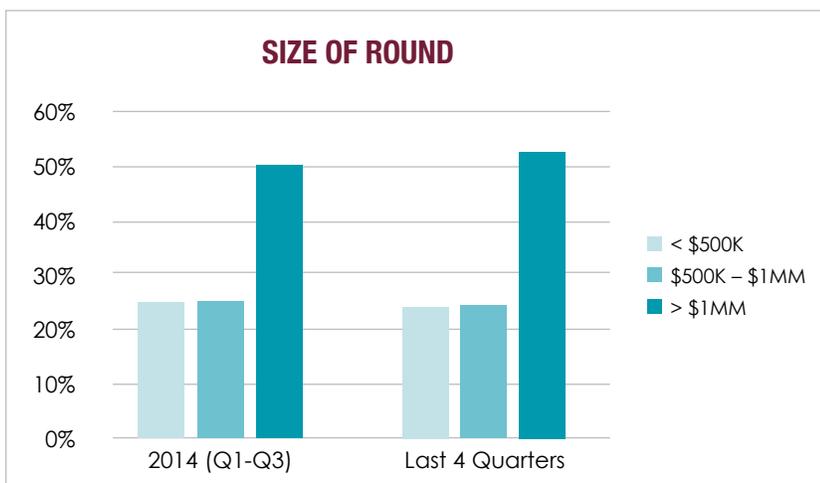
- Amounts raised in SAFE rounds are getting closer to those in convertible note rounds – the median SAFE raise in the last four quarters was \$810,000.
- The median valuation cap for SAFEs in the last four quarters was \$8,000,000.
- Investors were promised the grant of preemptive (pro rata) rights in the next round in 70% of SAFE rounds.

# THE DATA: CONVERTIBLE NOTE ROUNDS

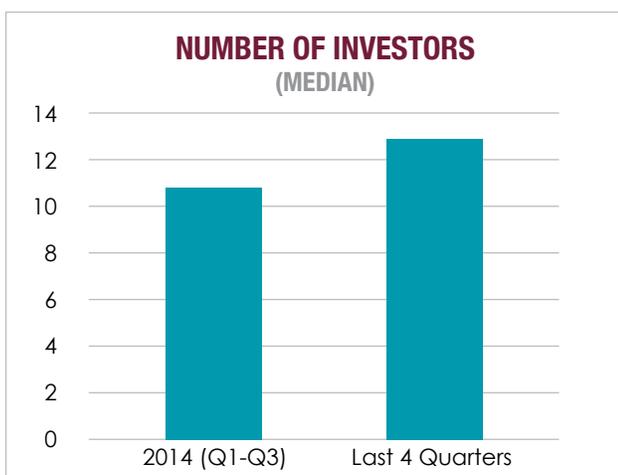
## Who is in – and for how much?



The amount of money raised by companies using convertible notes continues to grow, with the median raise this year of \$1 million. This was an increase from the median of the prior three quarters of \$950,000.



There continues to be an increase in the number of companies raising more than \$1 million using convertible notes. A majority of companies have raised at least \$100,000 in their note rounds.

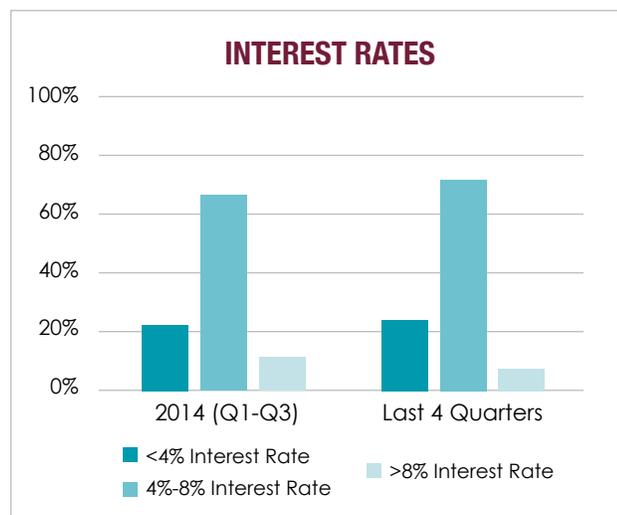


The phenomenon of “party rounds” is holding steady as companies include higher numbers of investors in their note rounds. We saw a median of 13 investors per note round during the last four quarters.

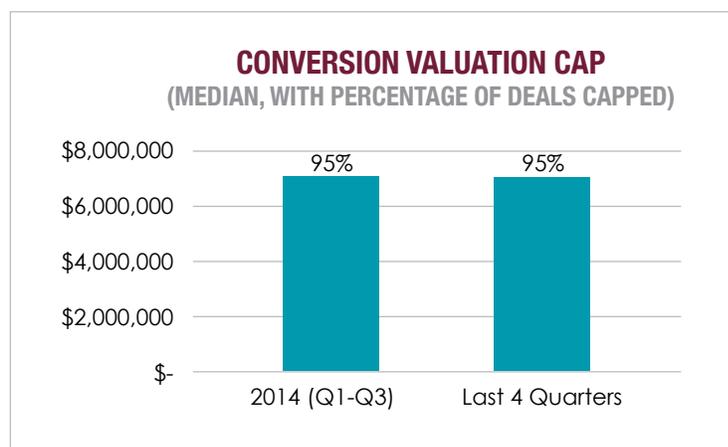
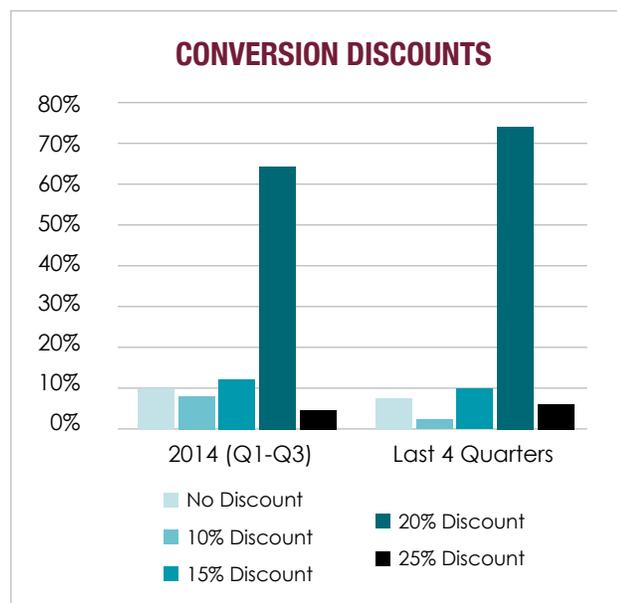
# THE DATA: CONVERTIBLE NOTE ROUNDS

## Making it worth the investors' while...

**Interest Rates.** The principal invested via convertible notes typically accrues simple interest. Interest rates range from the applicable federal rate ("AFR"), a rate minimum set by the IRS (usually around or below 1%) to the maximum rate allowable under the applicable state's "usury" laws. In a strong majority of note deals, the interest rate falls in the range of 4% to 8%.



**Conversion Discounts and Caps.** Conversion discounts and conversion caps are "sweeteners" that reward early investors by granting them the right to convert their principal plus interest into equity at a reduced price relative to the purchase price paid by the new investors in the next equity round. Conversion discounts specifically provide for a percentage discount against the new round price. Our data shows that conversion discount is typically 20%. Conversion caps, on the other hand, are ceilings on the value of the company for purposes of determining the conversion price. Caps protect a note investor's stake from being swallowed up in the event of a sky-high pre-money valuation at the next equity round. Our survey data shows that the valuation caps have continued increasing to a median of \$7.5 million.

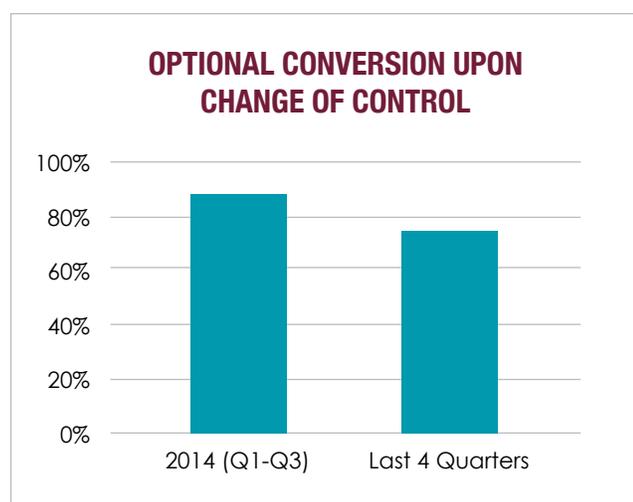


**Warrant Coverage.** While more frequently used in the past as a sweetener in lieu of conversion discounts, warrants are no longer favored as a means of compensating the investors with additional equity. In the last four quarters, warrants were used in 1% of note deals.

# THE DATA: CONVERTIBLE NOTE ROUNDS

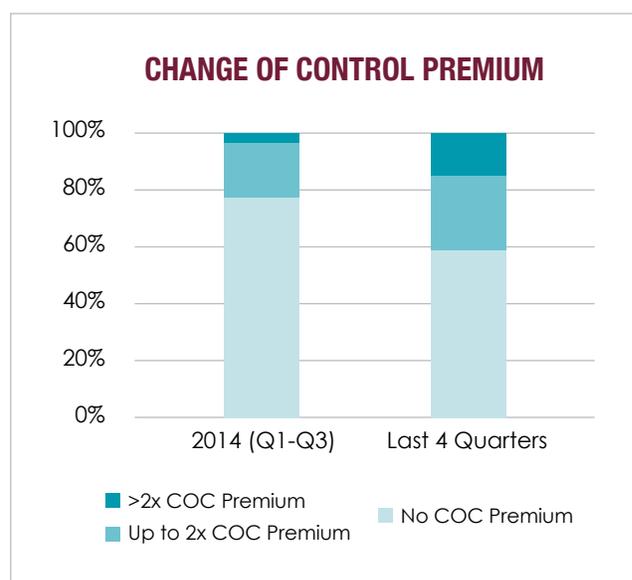
## When the company is acquired before conversion...

Pre-equity round acquisitions have become a more common occurrence. In some cases, companies reach significant milestones with the larger amounts of money they have raised using notes. In others, companies fail to achieve traction despite a large note funding and need to find a “soft landing.” Unlike the control rights associated with equity investment, note investors almost always lack the contractual right to veto a sale of the company.



Seeking to capture upside and maintain more control over their destiny, note investors often want the option to convert their principal plus interest into equity upon an acquisition (in lieu of repayment of the note). Such conversion typically occurs at the conversion cap valuation or the fair market value of the equity implied by the acquisition (or some discount thereof). Investors continue to demand this optional conversion right in vast majority of deals.

Another sweetener upon an acquisition is the right to receive a premium on top of the principal plus interest. The premium is typically set at a multiple of the principal amount of the note. Change of control premiums are still not the norm, but they are being used more frequently.



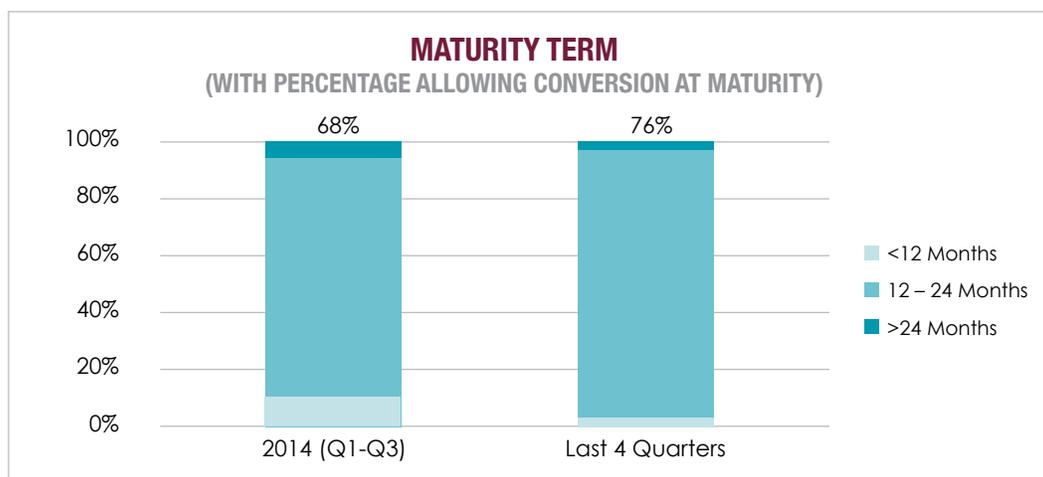
# THE DATA: CONVERTIBLE NOTE ROUNDS

## Other Points of Data

### When is the note due? What happens upon maturity?

The maturity term for convertible notes (the “due date” for the loan) typically falls within a 12 to 24 month range. In practicality, note maturity is not a hard-and-fast “end of the line” for the company. Because most note investors are seeking the equity upside and do not invest for the purpose of earning interest income, they are often willing to extend the term of the note to give the company a longer runway to reach a Series A round. Across our portfolio of company clients, we could not find any examples of note investors forcing a company into bankruptcy when the notes came due.

Along these lines, a note investor’s worst fear is not that they will lose the money they have invested. Instead, investors worry that the company will successfully use the note round proceeds, pay the investors back at the end of the note term, and then sell the company for \$1 billion twelve months later. As a result, investors often want the right to convert their principal plus interest into equity upon maturity in lieu of repayment of the note. The trend is for more and more notes to allow for such optional conversion (into either Common Stock or Preferred Stock).



### Other Note Terms:

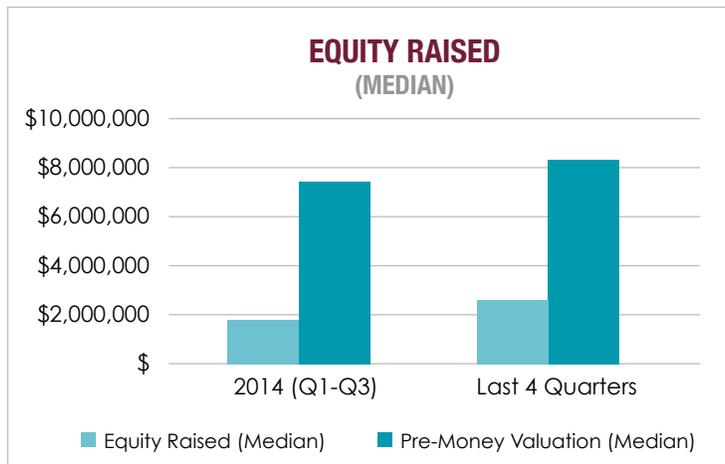
#### FREQUENCY OF OTHER NOTE TERMS

|                                 | 2014 (Q1-Q3) | Last 4 Quarters |
|---------------------------------|--------------|-----------------|
| Notes Secured by Company Assets | 0%           | 0%              |
| Board Seats for Note Investors  | 2%           | 6%              |
| Most Favored Nation Protection  | 15%          | 16%             |
| Preemptive (Pro Rata) Rights    | 25%          | 52%             |

Convertible notes issued in seed rounds are almost always unsecured; and it is still quite unusual for a note investor to receive a board seat. Investors are increasingly asking for the right to invest additional capital in subsequent rounds.

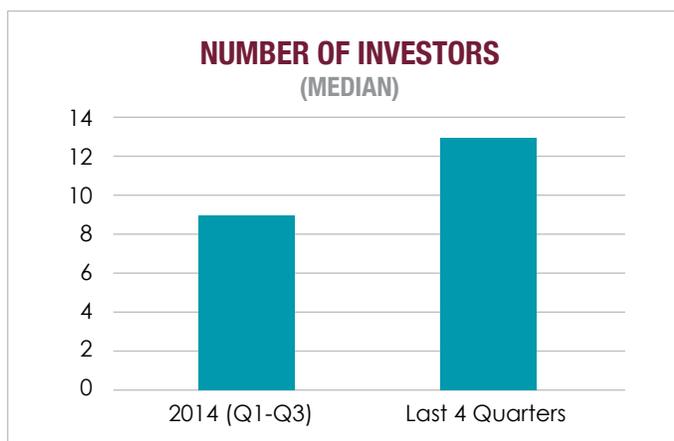
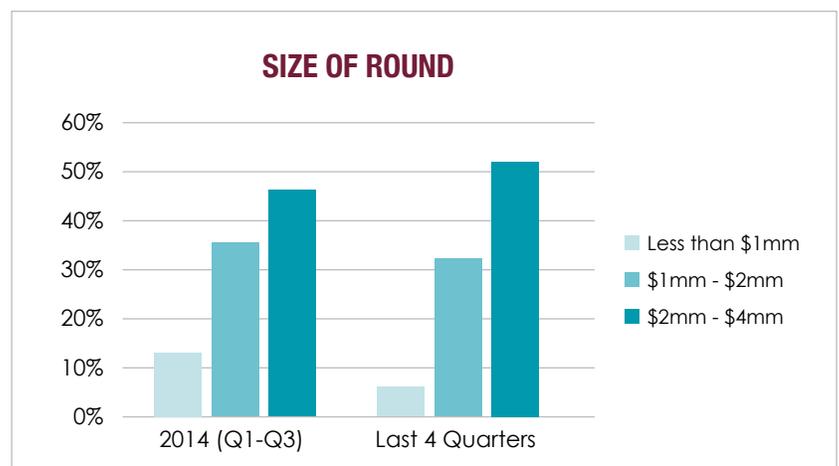
# THE DATA: EQUITY ROUNDS

## Who is in – and for how much?



Median investment size was \$2.7 million, which is a 35% increase from the prior three quarters. Median pre-money valuation also increased by 10% to \$8.3 million.

A majority of deals raised more than \$2 million and only 6% of deals raised less than \$1 million.



The phenomenon of “party rounds” continues as the median of 13 investors participated in each equity round.

# THE DATA: EQUITY ROUNDS

## Economic Rights and Control Provisions

The trend over the last few years has been for the investors to ask for the same bundle of basic economic and control rights that are typically a part of "Series A" rounds. In particular:

**Investor Board Seats.** We are seeing investors take board seats in a vast majority of seed equity deals as investors look to assume a more hands-on role.

**Pro Rata Rights.** All or at least a subset of investors were given the right to invest additional capital in subsequent rounds in more than 95% of seed equity deals. Often, the company will set a minimum investment threshold that must be met in order for investors to enjoy pro rata rights. However, we are seeing more and more seed deals where all investors in the round are receiving pro rata rights. Further, where thresholds are set, they are trending lower.

### ECONOMIC AND CONTROL RIGHTS GIVEN TO EQUITY INVESTORS

|   | 2014 (Q1- Q3) | Last 4 Quarters |
|---|---------------|-----------------|
| Preemptive (Pro Rata) Rights                  | 95%           | 96%             |
| No investment threshold required              | 21%           | 38%             |
| Up to \$100,000 investment threshold required | 58%           | 44%             |
| Over \$100,000 investment threshold required  | 21%           | 18%             |
| Non-participating Preferred Stock             | 97%           | 99%             |
| Amount of Liquidation Preference              |               |                 |
| 1x Preference                                 | 99%           | 100%            |
| >1x Preference                                | 1%            | 0%              |
| Anti-Dilution Protection                      | 85%           | 94%             |
| ROFR and Co-Sale Rights                       | 88%           | 96%             |
| Drag-Along Rights                             | 82%           | 89%             |
| Redemption Rights                             | 3%            | 2%              |
| Investor Board Seat                           |               |                 |
| No Seat                                       | 8%            | 7%              |
| 1 Seat  | 84%           | 85%             |
| >1 Seat                                       | 8%            | 8%              |
| Standard Protective Provisions                | 100%          | 100%            |

# THE DATA: “SAFE”

## Basic Deal Terms

Simple agreement for future equity “SAFEs” are intended to be a simpler alternative to convertible notes and do not have as many terms to negotiate. For example, since a SAFE is not a debt instrument, it does not have a maturity date or accrue interest.

**Investment Amount.** As has been the case historically, the amount of capital raised using SAFEs has been lower than amounts raised under convertible notes, with the median raise of \$810,000 during the last four quarters. However, this is a significant increase from the median raise of \$500,000 in the prior three quarters.

**Number of Investors.** The phenomenon of “party rounds” is growing with SAFEs, as the median number of investors has increased to 15.

**Valuation Cap.** The median valuation cap of \$8,000,000 is actually higher than that for convertible note rounds. This is at least partly because SAFEs are used most often by companies coming out of the Y Combinator ecosystem.

| SAFE TERMS                        |              |                |     |
|-----------------------------------|--------------|----------------|-----|
|                                   | 2014 (Q1-Q3) | Last 4 Quaters |     |
| Equity Raised (Median)            | \$500,000    | \$810,000      |     |
| Number of Investors (Median)      | 7            | 15             |     |
| Valuation Cap (Median)            | \$5,000,000  | \$8,000,000    |     |
| Discount                          |              |                |     |
|                                   | No Discount  | 29%            | 50% |
|                                   | 20% Discount | 71%            | 50% |
| Conversion upon Change of Control | 100%         | 100%           |     |
| Change of Control Premium         |              |                |     |
|                                   | No Premium   | 53%            | 59% |
|                                   | > 1x Premium | 47%            | 41% |
| Preemptive Rights                 | 89%          | 90%            |     |
| Most Favored Nation               | 14%          | 30%            |     |

**Price Discount.** Only half of the deals included a conversion price discount.

**Change of Control.** While all deals allowed for conversion upon a change of control, a majority did not include a change of control premium.

**Preemptive Rights.** As consistent with seed note and equity deals, most SAFE deals include a promise to grant pro rata rights in the next equity round.

**MFN.** Most Favored Nation provisions require amendment of the SAFE if the company subsequently issues SAFEs with more favorable terms to other investors. MFNs provisions are more common in deals with no discount or valuation cap.

# ADMINISTRIVIA

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Silicon Legal Strategy is the premier boutique law firm providing targeted, bottom-line-oriented advice to technology startups, innovative entrepreneurs and seasoned investors. Trained at the top firms in Silicon Valley, our attorneys and staff are incredibly passionate about technology and have extensive experience representing early stage companies and investors. We are a known quantity in Silicon Valley, and work with or sit across the table from every major law firm in the area. Perhaps most importantly, we ourselves are entrepreneurs. We truly understand the challenges of a startup -- like building and motivating a team, creating repeatable processes to ensure continued customer satisfaction at scale and dealing with infrastructure issues. We face these challenges every day -- and as a result, are able to deliver more relevant, bottom-line-oriented advice. Put simply, we actually "get" what entrepreneurs are going through.

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