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inBrief

Venture Financing

By Shahram Safai and Mohammad Nawash | 25 January 2023

This inBrief highlights the different aspects of venture capital, an important source of raising money for start-up companies which do not have access to capital markets. We discuss the different types of venture financing through which start-ups can raise money and which are taken into account when assessing valuations.

Types of Venture Financing

Although there are different forms of venture financings that can be utilised by start-ups depending on their needs and goals, it should be noted that generally a start-up can only raise financing through issuing equity or debt. Therefore, venture financing is fundamentally provided as a form of debt or equity. When deciding which form of equity or debt to pursue, it is important to bear in mind 'maturity', 'valuation' and any other 'preferences' awarded to investors.

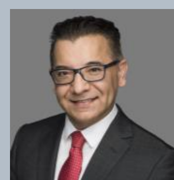
Below we set out the common types of structures for venture financings and the typical terms which may apply.

1. **Convertible Promissory Notes**

This form of venture financing is a debt security convertible into equity upon the occurrence of a certain conversion event. Such conversion event could encompass a financing round, a liquidation event or even an initial public offering. This is an effective method for start-ups to raise capital without the cost, time, and complexity of a preferred stock financing as it involves minimal negotiations with investors and significantly less volume of documentation. As these notes are a debt security, the start-up does not require to conduct a company valuation. While these convertible promissory notes are considered as debt, investors could benefit from accrued interest payable to the note holder upon maturity as stipulated in the terms of issuance of these promissory notes.

Upon the occurrence of a financing event, the notes often convert at a price that is lower than the price paid by the investors purchasing shares in a qualified financing round. This is because the conversion price is often determined and calculated based on either a discount

The Authors



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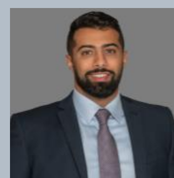

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rate (which is typically a percentage of the qualified financing's issue price) or a valuation cap (a cap on the pre-money valuation at which such notes may convert).

2. Simple Agreement for Future Equity (SAFE)

A SAFE is similar to the process of issuing a convertible promissory note. A start-up could issue a SAFE to the investor as a promise of repayment. This typically means that the SAFE converts in the same manner as a convertible promissory note, but because a SAFE is not considered a debt instrument, it does not accrue any interest and it does not have a maturity date. Consequently, a SAFE is left outstanding until a qualified financing or corporate transaction triggers conversion of or payment on the SAFE. Upon conversion, the SAFE coverts into a number of shares of preferred stock, determined by dividing the purchase price of the SAFE by the applicable conversion price, which is normally calculated based on either a discount rate (which is typically a percentage of the qualified financing's issue price), or a post-money valuation cap at which the SAFE may convert. The terms of the SAFE often stipulate that the choice of calculation would be the calculation which results in the greater number of shares.

3. Preferred Stock Financings

This type of equity financing involves issuing preferred stock to venture investors at a substantial premium over the price charged to the founders or the seed investors. As a justification to the premium paid for the shares, investors are given preferential treatment. This could take form of a liquidation preference and other preferential rights over holders of common stock as well as certain voting rights. This helps start-ups classify shares according to the investment rounds and also justifies a lower price (lower than is paid by preferred investors) for common stock to its employees.

Assessing Valuations

Pre-money valuations of a start-up are provided as an indication in a given financing round which investors take into consideration when determining the company's development stage and assess their investment potential prior to investing.

The pre-money valuation is carried out based on the price per share that the investors are offering to pay the start-up company multiplied by the total number of shares outstanding (including options, other convertible securities and shares reserved for employee stock options).

The standard position for start-ups to determine valuation is by contrasting the company's position in the future with the desired rate of return by the investors for the near future. However, in practice venture capitalists tend to estimate the amount of cash required to achieve some development milestone and equate that amount to a certain percentage of the company. It is often the case that a start-up company in the UAE is likely to be valued on a similar scale at what valuations venture capitalists have been giving to other companies with a similar business model. Following a financing round, the start-up company's post-money valuation can be determined by adding the amount of money invested in the financing to the pre-money valuation. ■

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For more detailed information, please do not hesitate to contact Shahram Safai at ssafai@afridi-angell.com.

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