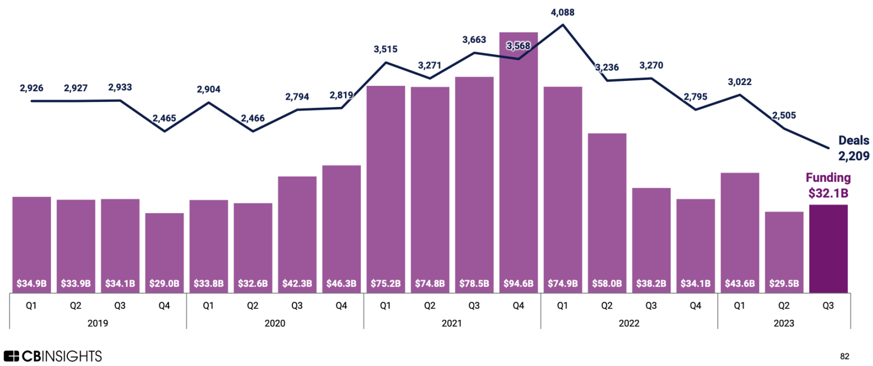
THE NEW RULES OF EARLY-STAGE VENTURE CAPITAL VALUATION AND POTENTIAL RESPONSES: MEET THE BRIDGE SAFE AND EXTENSION ROUND



In our current economic environment, you would have to be hiding in a cave not to see, hear and feel valuations sliding downwards across the eco-system. It started in January 2022 when large-cap, mid-cap and then smaller-cap public companies started to fall in price. Past a certain point, we began to see private equity and venture capital investors applying these lessons to late stage private companies. In the time since February, we have seen the slide come all the way through the business food chain until it reached the startup.

In the global Silicon Valley, venture capital firms are getting much more cautious when it comes to valuation points when deciding to invest in new deals, and startups are facing an interesting dilemma. Do they risk waiting for future funding rounds when they would likely have to sell shares at a reduced price, or do they look for a more creative solution?

What's happening, really? We are seeing plenty of venture capital funds with fresh piles of dry powder – the capital is present. But private equity and venture capital investors made promises to their own limited partner investors and need to return capital and make returns.

What is the venture capital POV? VCs are seeing later stage companies getting next rounds of capital and exits at valuations based on lower multiples of revenue, and then, only if it's not unprofitable, and only on last twelve months, not future projected twelve months. VCs are applying these lessons to the seed- and early-stage of the market. We are seeing VC term sheets with lower valuations and liquidation preferences based on seniority of last money-in and often times a return at greater than one time (e.g., VC gets its money back plus a return before the common participates).

If you are a startup founder, how do you navigate these conditions in the equity markets?

First off, bridging with a SAFE is often a good bet. We are not (yet) seeing investors play with SAFE terms on the YCombinator form. We are seeing the occasional side letter accompanying a SAFE investment, but usually containing only pro rata rights, information rights and rights to sit in or participate on the board of directors. If you are a pessimist, however, you might consider whether valuations slide further in startup land, allowing SAFEs to convert later into a lower valuation.

Another tool in the toolbox is the "extension round." Historically, an "extension round" referred to a startup that raised additional capital on the same instrument at the same valuation and terms when it was running out of money before it had achieved the funding milestones for the subsequent round that had been anticipated. Alternatively, it was used as a way to take in "corporate" venture capital between rounds. Either way, it was additional capital at the same price to carry on.

Extension rounds can help protect the startups valuation as shares are typically priced at the rate of the previous round, or sometimes higher, and usually have the same terms. They can also help to buy some much needed time before the next major funding round.

In 2022, however, as chronicled in the annals of [Tech Crunch]() and elsewhere, startups have turned to the extension round as a substitute for the next round. This is because your next round is a signal to the market, to investors, to competitors and to your employees, that you have achieved increase. If the valuation you would get upon a "next" round looks potentially flat or even down, rather than have that discussion, it's much easier and more palatable to talk about extending the same round.

If you're looking at an extension round, there are some points to consider:

- There must be interest from investors: If you're going back to existing investors for an extension round, then it's going to be important that those investors have a reason to invest further in the company. That means keeping them engaged and giving them a reason to be excited about the trajectory of the company. Show them growth, projections, positive news that would lead them to further investment.
- Cut costs first: Investors are going to want to see where you have cut costs before you ask them for additional funds. Make sure you are operating at the highest level of efficiency and don't have any excess or unnecessary expenses. It's much easier to make the case if you have this area buttoned up.
- Will an extension round get you where you need to be: If you secure an extension round and buy yourself a few months, will this help you to meet the necessary milestones for your next funding round? Really take a look at how this additional funding and time will prepare you for the next round. If you don't think it will get you where you need to be, you might want to consider other alternatives.
- What is the impact to key employees and founders of the extension capital on the common stock? How much is left in the equity incentive plan? Can you make some grants at the same time as the extension round? Do you need to increase the plan? If so, the hill to get to an upround for the next round just got steeper.

Extension rounds won't be the right option for every startup, and there are certainly many options out there when it comes to raising money. Do your research, weigh all your options, and consult with your trusted advisors before deciding what is right for you.