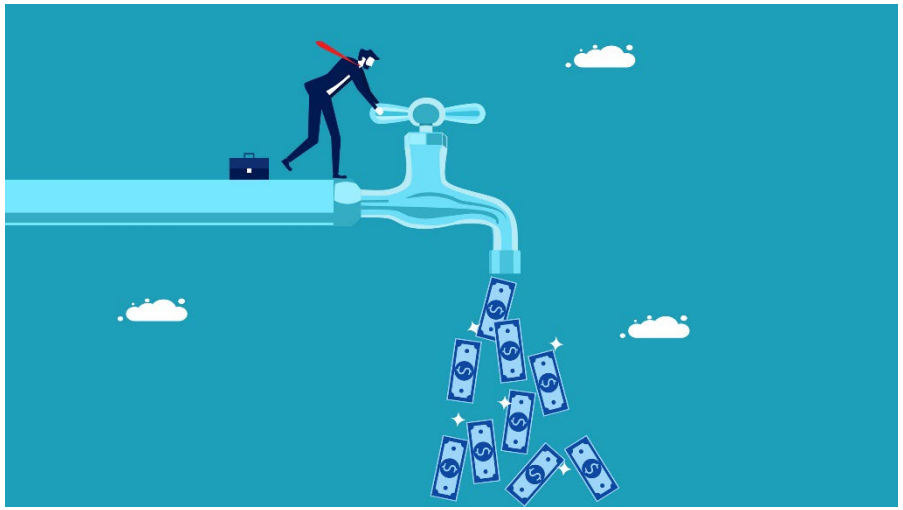


The Flow of Funds: How to Make Cap Tables Flow Like Water

How to Use Cap Tables to Analyze Mergers and Acquisitions of VC-Backed Startups

This Lesson: Flow of Funds Crash Course

For the files and resources, please go to:

https://breakingintowallstreet.com/kb/venture-capital/flow-of-funds/

(Excerpt from our VC & Growth Equity Course.)

This Lesson: Flow of Funds 101

"Flow of Funds" can refer to dozens of concepts in finance (macro drivers, investment funds, banks, etc.).

But we'll focus on the type that tells you the **proceeds to different investor groups** in M&A deals here.

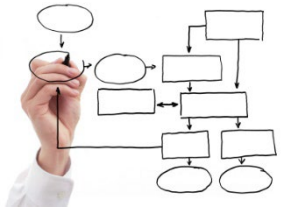
Flow of Funds: Lesson Overview

- **Part 1:** Flow of Funds: The Short Version **1:59**
- **Part 2:** Cap Table Data, Exit Price, and Conversion Combos **3:34**
- **Part 3:** Liquidation Preferences **5:08**
- **Part 4:** Participating Preferred Logic **6:56**
- **Part 5:** Common Share Counts and Options **9:35**
- **Part 6:** Net Proceeds and Multiples **13:43**

Part 1: The Short Version

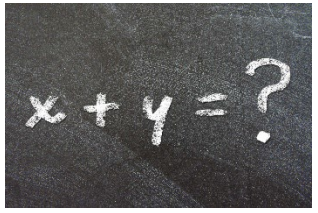
- **Purpose:** Tells you *how much* goes to each different VC investor, the employees, and the founders in an M&A deal

- **And:** Also tells you whether each group *should* convert their preferred shares into common, exercise their options, etc.



- **Relevancy:** Mostly for M&A deals because preferred shares normally all get converted into common in an IPO

- **Why:** With only 1 – 2 investor groups, you can write simple formulas to do this, but this approach gets **unwieldy** with more groups and terms; best to run a "simulation"

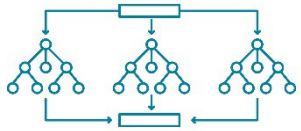


Part 2: Cap Table Data and Exit Price

- **Required:** # shares owned by each group, exercise prices for options, liquidation preferences, participating preferred, caps

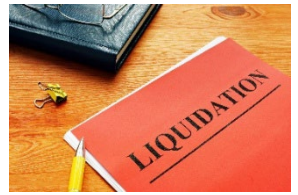
- **Exit Price:** Typically a multiple of revenue or EBITDA, depending on the company/industry and the comparables; remember to subtract Net Debt to get the Equity Value

- **Conversion Combinations:** Plot out each possible decision here (e.g., Series A investors convert to common, but Series B and C investors do not; will be 2^n total combinations)

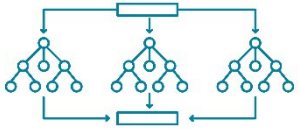


Part 3: Liquidation Preferences

- **Each Level:** If the VC investors stay in preferred stock, they receive their Liquidation Preference back upon exit and no common shares (don't know what they'll do in advance)



- **BUT:** Must check this against the remaining available proceeds in each case – if only $15M in proceeds remain, the investors won't earn a $20M Liquidation Preference



- **Each Level:** Subtract the Liquidation Preference paid out to get the "next" Remaining Proceeds number

Part 4: Participating Preferred Logic

- **Double Dip:** Participating Preferred means the VC investors get their Liquidation Preference *and* a percentage of the Remaining Proceeds, as if they also converted into common

- **But:** Often has **Participation Caps** attached to prevent abuse

- **So:** If this term exists, distribute the Ownership of Common Shares % * Remaining Proceeds

- **But:** Enforce a limit by comparing this to the Participation Cap – Liquidation Preferences and distribute the minimum

Part 5: Common Share Counts and Options

- **Multiply** each investor group's conversion decision by its CSEs; no check for true common shareholders

- **Share Price:** Divide the Remaining Proceeds After All Liquidation Preferences and Participating Preferred by the Total Common Shares

- **Options/Warrants:** Assume they convert into common shares if this Share Price exceeds the Exercise Price

- **And:** Only do this check if circular references are enabled; poor practice to leave in circular references by default

Part 6: Net Proceeds and Multiples

- **Net Proceeds:** Add up everything for all investor groups and subtract the exercise costs for option/warrant holders

- **Optimal Decisions:** Add up all VC investor proceeds and use MAX to determine the best conversion decisions

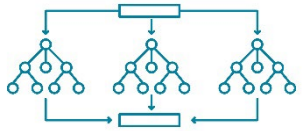
- **Then:** Add the actual amounts for each group based on this column and calculate the multiples and sensitivities

What Makes the Flow of Funds **More Difficult?**

- **Option Types:** Treatment of vested vs. unvested vs. exercisable options varies in deals

- **True Purchase Price:** Earnouts, Working Capital adjustments, and escrows complicate things

- **Investor Priority:** Based on ownership? Pari passu?



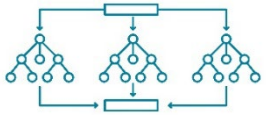
- **Securities:** Convertible bonds, SAFEs, venture debt, etc.

- **Too Many Combinations:** Not viable to do this for 8 groups since $2^8 = 1{,}024$; need VBA or similar automation

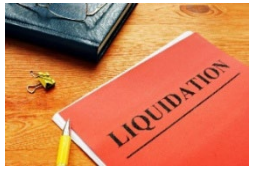
Recap and Summary

- **Part 1:** Flow of Funds: The Short Version

- **Part 2:** Cap Table Data, Exit Price, and Conversion Combos



- **Part 3:** Liquidation Preferences



- **Part 4:** Participating Preferred Logic

- **Part 5:** Common Share Counts and Options

- **Part 6:** Net Proceeds and Multiples