



Making Growth Happen.

**Equity Instruments: An Investor's
Guide**

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1.0 Introduction

Overview

This guide has been prepared to help investors develop a practical understanding of the equity instruments commonly encountered in private and public markets. Each instrument represents a different mechanism through which capital is deployed, returns are generated, and risk is allocated between parties.

1. Common Stock & Preferred Stock:

Common and preferred stock are the primary forms of direct equity ownership. Common stock generally carries voting rights and residual economic claims, while preferred stock typically provides priority in dividends and liquidation, often with reduced voting rights.

2. Convertible Notes & SAFE Notes:

Convertible notes and SAFE notes are commonly used in early-stage financing to delay valuation until a later funding event. Convertible notes function as debt instruments with interest and maturity terms, whereas SAFE notes provide a simpler mechanism for future equity conversion without traditional debt features.

3. Options, Warrants & Units/Fund Equity:

Options and warrants provide rights to acquire shares at a fixed price, with differences in structure and issuance. Units and fund equity, by contrast, represent an ownership interest in a pooled investment vehicle rather than direct ownership in an operating company.

2.0 Equity vs. Debt Instruments



Equity instruments give investors an ownership interest in a company, with returns linked to business performance through dividends and capital appreciation. Equity holders generally take on more risk, but also have greater upside potential.



Debt instruments represent borrowed capital that must be repaid under agreed terms. Investors do not receive ownership, but instead earn returns through interest payments and repayment of principal. Debt holders typically have priority over equity holders in insolvency.

Feature	Equity Instruments	Debt Instruments
Nature	Ownership in the company	Contractual lending claim against the company
Return	Dividends and capital growth	Interest and principal repayment
Risk	Generally higher risk	Generally lower risk
Upside	Higher potential upside	Capped return profile
Control	Often carries voting and governance rights	Typically carries no voting or ownership rights
Liquidation priority	Paid after creditors	Paid before equity holders

In practice, the choice between equity and debt depends on a company's stage of growth, cash flow profile, cost of capital, and desired ownership structure.



3.0 Common Stock

What is Common Stock?

Common stock represents an ownership interest in a corporation. It typically gives shareholders voting rights and a residual claim on the company's profits and assets after creditors and preferred shareholders have been paid. As the primary form of equity ownership, common stock allows investors to participate in long-term company growth through dividends and capital appreciation.

Key Terms

Voting rights

- Common shareholders typically receive one vote per share and may vote on directors and major corporate matters

Dividend rights

- Dividends are discretionary and depend on board approval, profitability, and company policy
- Paid after preferred shareholders; not guaranteed in any period

Liquidation rights

- Common shareholders rank last in liquidation, behind all creditors and preferred shareholders
- In a distressed sale, common shareholders may receive little or nothing

Classes of shares

- Companies may issue multiple share classes with differing economic or voting rights
- Different classes may carry different voting or economic rights

Advantages	Disadvantages
Capital appreciation potential	Dividends not guaranteed
Voting rights and governance participation	Last priority in liquidation
Full participation in upside	Greater price volatility



3.1 Common Stock Example

Share Type:
Ordinary Shares

Total Shares Issued:
2,000,000

Share Price:
\$15

Market Capitalization:
\$30,000,000

Key Features

Voting Rights

Each ordinary share grants the holder one vote at shareholder meetings, allowing them to influence company decisions, such as electing the board of directors and approving major corporate actions.

Dividend Payments

Dividends are discretionary and are paid only when declared by the board.

For example, if the company declares a dividend of **\$0.50** per share

Total dividends to ordinary shareholders would equal:

2,000,000 shares

X

\$0.50

=

\$1,000,000 in total dividends

Capital Appreciation

Ordinary shareholders benefit from any increase in the company's stock price.

If share price increases

\$15 → \$20

THEN

The investment value increases as the share price rises.

Last Claim on Assets

Ordinary shareholders are paid only after creditors and preferred shareholders have been satisfied.

Company sold:
\$30M

-

Creditors owed: \$15M

Preferred Shareholders
owed: \$10M

=

Ordinary Shareholders only
receive: \$5M

4.0 Preferred Stock

What is Preferred Stock?

Preferred stock is a class of equity that typically provides holders with priority over common shareholders in relation to dividends and liquidation proceeds. In exchange for this enhanced economic position, preferred shareholders often have limited voting rights and lower participation in the company's upside unless conversion rights apply.

Key Terms

Voting rights

- Preferred shareholders typically have limited or no ordinary voting rights
- In some structures, voting rights may arise if dividends remain unpaid or if class rights are being varied

Dividend rights

- Preferred shares usually carry a stated dividend rate or amount
- Preferred dividends must generally be paid before any dividends can be paid on common shares

Liquidation rights

- Preferred shareholders rank ahead of common shareholders in a liquidation or wind-up
- They are generally entitled to receive a specified amount before common shareholders participate in any remaining proceeds

Conversion rights

- Some preferred shares may be converted into common shares
- This can allow investors to participate in future equity upside

Redemption rights

- Some preferred shares are redeemable in accordance with the terms of issue
- Usually redeemed at par value plus any unpaid dividends

Advantages

Priority over common shareholders for dividends

Priority over common shareholders in liquidation

More predictable income profile than common stock

Disadvantages

Limited or no ordinary voting rights

Lower upside than common stock unless converted

More complex terms and conditions

4.1 Series A Preferred Stock Example

Share Type:
Series A Preferred Shares

**Preferred Shares
Issued:** 1,000,000

Share Price:
\$10

Total Investment:
\$10,000,000

Key Features

Voting Rights

Preferred shareholders typically have limited ordinary voting rights, but may have class-based protective rights over matters such as issuing senior securities, varying class rights, or approving a sale of the company.

Dividend Rate

In this example, the Series A preferred shares carry a stated 8% dividend rate. Preferred dividends must be paid before any dividends can be distributed to common shareholders.

Convertibility

Each Series A preferred share may be converted into one common share at the holder's option. Conversion allows investors to participate in common equity upside if the as-converted value exceeds the liquidation preference.

Liquidation Preference Amount

In this example, the Series A preferred shares carry a 1x liquidation preference. In a sale or liquidation, holders are entitled to receive an amount equal to their original issue price (\$10 per share) before any proceeds are distributed to common shareholders.

**Exit
Event**

Acquisition price: \$30M

Series A preference: \$10M

**Remainder to common
shareholders: \$20M**

Assumption:
Assume Series A
remains unconverted
and elects its 1x
liquidation preference.



5.0 Convertible Notes

What are Convertible Notes?

A **convertible note** is a short- to medium-term debt instrument commonly used by startups to raise early-stage capital. It begins as a loan, accrues interest, and typically converts into equity upon a future financing event, often at a discount or subject to a valuation cap. If no conversion event occurs before maturity, the note may become repayable or be renegotiated.

Key Terms

Principal amount

- The initial amount invested by the noteholder as a loan to the company

Maturity date

- The date on which the note becomes due if it has not converted into equity.

Interest

- Convertible notes accrue interest over time. Accrued interest is often added to the principal and converted into equity together with the note balance.

Conversion event

- A future priced financing round that triggers the note converting into equity

Conversion discount

- Noteholders often convert at a discount to the share price paid by new investors in the next financing round

Valuation cap

- A maximum valuation used to calculate a more favourable conversion price for early investors

Advantages	Disadvantages
Lower upfront legal costs	Repayable if no conversion occurs
Faster and simpler negotiations	Interest increases the balance
Delays valuation and dilution	Caps and discounts increase dilution

5.1 Example: Convertible Notes

Principal Amount:
\$500,000

Interest Rate:
8%

Discount:
20%

Valuation Cap:
\$5,000,000

Maturity:
12 months

Key Features

Principal and Interest

The noteholder provides a \$500,000 loan to the company. The note accrues 8% annual interest, increasing the balance that will convert into equity.

\$500,000

X

8%

=

\$40,000

Total converting balance
= \$540,000

Conversion Trigger

The note converts into equity when the company completes its next priced financing round. The company raises a Series A round at **\$1.00** per share.

Conversion Discount

Because the note includes a 20% discount, the noteholder converts at a lower price than the new Series A investors.

Series A price:
\$1.00/share

Discounted conversion price:
\$0.80/share

Shares Issued on Conversion

The \$540,000 converting balance at \$0.80 per share results in 675,000 shares.

\$540,000

÷

\$0.80

=

675,000 shares

Valuation Cap

If the valuation cap produces a lower conversion price than the discount, the noteholder converts at the cap price.

Series A price:
\$1.00/share

Cap price:
\$0.625/share

\$540,000

÷

\$0.625

=

864,000 shares

Noteholder converts at the cap price because it is more favourable.



6.0 SAFE Notes

What are SAFE Notes?

A SAFE (Simple Agreement for Future Equity) is an instrument commonly used by startups to raise early-stage capital. Unlike a convertible note, a SAFE is not debt: it does not accrue interest and has no maturity date. Instead, it gives investors the right to receive equity in the future upon specified triggering events, usually a later priced financing round.

Key Terms

Conversion event

- A specified event that causes the SAFE to convert into equity
- This usually occurs when the company completes a future priced financing round

Conversion Discount

- A discount applied to the share price paid by new investors in the next financing round
- This allows SAFE investors to convert at a more favourable price

Valuation Cap

- A maximum company valuation used to determine the conversion price
- It protects early investors if the company's valuation rises significantly before the next round

Maturity and Interest

- SAFEs do not accrue interest because they are not debt instruments
- SAFEs do not have a repayment deadline or maturity date
- They remain outstanding until a specified triggering event occurs, depending on their terms

Advantages	Disadvantages
Simple and quick to issue	Fewer investor protections
Lower legal and negotiation costs	No repayment right
No interest or maturity date	Future dilution can be difficult to predict
Defers valuation until a later financing round	Can complicate later funding

7.0 SAFE vs. Convertible Notes



Convertible notes are debt instruments used by startups to raise early-stage capital. They accrue interest, usually include a maturity date, and typically convert into equity upon a future priced financing round, often at a discount or subject to a valuation cap.



SAFE notes are contracts for future equity rather than debt instruments. They do not accrue interest and have no maturity date. Instead, they convert into equity upon specified triggering events, usually a later priced financing round, often using a discount or valuation cap.

Feature	Convertible notes	SAFE notes
Legal nature	Debt instrument	Not a debt instrument
Interest	Accrues interest	No interest
Maturity date	Has a maturity date	No maturity date
Repayment	May become repayable if no conversion occurs	No loan-style repayment obligation
Investor protection	Generally stronger investor protections	Fewer investor protections
Company impact	More debt-like pressure on the company	More founder-friendly structure
Typical use	Bridge or interim early-stage funding	Simple early-stage fundraising where valuation is uncertain

In practice, convertible notes are often used when investors want stronger protections and debt-style terms, whereas SAFEs are more suitable when startups want a simpler, faster, and more founder-friendly early-stage funding instrument.



8.0 Options

What are Options?

Stock options give the holder the right, but not the obligation, to purchase company shares at a predetermined price, known as the exercise or strike price, before a specified expiry date. In private company settings, stock options are commonly used as equity compensation for employees, executives, and advisers, allowing them to participate in future upside if the company's value increases.

Key Terms

Type of options

- Option types may differ depending on who receives them and the rights attached to them

Number of options granted

- The number of shares the holder may purchase if the options are exercised

Exercise price

- The predetermined price at which the holder may purchase shares

Vesting schedule

- The vesting schedule determines when the holder earns the right to exercise the options
- Vesting may be time-based, milestone-based, or a combination of both

Expiry date

- The final date by which the option must be exercised before it lapses

Advantages	Disadvantages
Aligns incentives with company growth	Dilutes existing shareholders when exercised
Allows participation in future upside	Usually subject to vesting and expiry conditions
Helps attract and retain talent	Value depends on future company performance
Reduces immediate cash compensation needs	Can be administratively and legally complex



8.1 Example: Options

Options Granted:
10,000

Exercise Price:
\$2.00/share

Vesting:
4 years, 1-year
cliff

Expiry Date:
10 years

Share Value at Exercise:
\$8.00/share

Key Features

Vesting

The employee does not receive all 10,000 options immediately. Instead, the options vest over 4 years, with 25% vesting after the first year and the remainder vesting in equal annual instalments thereafter.

Grant Date → **Year 1 Cliff** → **Year 2** → **Year 3** → **Year 4 Fully Vested**
2,500 2,500 2,500 2,500

Exercise Price

The employee may purchase shares for **\$2.00** each once the options have vested and are exercised.

Share Value at Exercise

If the company's share value rises to \$8.00 per share, the employee can exercise the options at \$2.00 per share and benefit from the \$6.00 difference.

Potential Gain on Exercise

Gain per Share

=

\$8.00

-

\$2.00

=

\$6

Total Gain

=

10,000

X

\$6.00

=

\$60,000

Expiry

If the employee does not exercise the options before the expiry date, the options lapse and no longer have value.

9.0 Stock Warrants

What are Warrants?

Warrants are instruments that give the holder the right, but not the obligation, to purchase company shares at a predetermined exercise price before a specified expiry date. They are typically issued by the company itself, often as part of financing transactions, and may provide investors with additional upside if the company's share value increases.

Key Terms

Number of warrants granted

- The number of shares the holder may purchase if the warrants are exercised

Exercise price

- The predetermined price at which the holder may purchase shares on exercise

Expiry date

- The final date by which the warrant must be exercised before it lapses

Issuer / financing context

- Warrants are typically issued by the company itself, often as part of a financing or investment transaction

Dilution on Exercise

- When warrants are exercised, the company issues new shares, which can dilute existing shareholders

Advantages	Disadvantages
Provides upside if the share price increases	Dilutes existing shareholders
Lower upfront cost than direct share purchase	May expire worthless
Enhances financing transactions	Can be administratively and legally complex
Flexible exercise period	Creates uncertainty around future dilution

9.1 Example: Stock Warrants

Warrants Issued:
100,000

Exercise Price:
\$5.00/share

Expiry Date:
5 years

Share Price at Exercise:
\$12.00/share

Issued as part of:
Financing round

Key Features

Financing Context

The company issues 100,000 warrants to investors as part of a financing transaction to enhance the attractiveness of the deal.

Exercise Price

The warrant holder may purchase shares at the predetermined exercise price of **\$5.00** per share.

Value at Exercise

If the company's share price rises to \$12.00 per share, the holder can exercise the warrants at \$5.00 and benefit from the increase in value.

Potential Gain on Exercise

Gain per Share = \$12.00 - \$5.00 = \$7

Total Gain = 100,000 X \$7.00 = \$700,000

Dilution Effect

If the warrants are exercised, the company issues new shares to the holder, which dilutes existing shareholders' ownership.

10.0 Options vs. Warrants



Options are commonly issued to employees, executives, advisers, or other service providers as a form of equity compensation. They give the holder the right to purchase company shares at a predetermined exercise price, usually subject to vesting and expiry conditions.



Warrants are typically issued to investors, lenders, or other third parties as part of a financing or investment transaction. They give the holder the right to purchase company shares at a predetermined exercise price before a specified expiry date and may provide additional upside if the company's value increases.

Feature	Options	Warrants
Typical holders	Employees, executives, advisers, or other service providers	Investors, lenders, or other third parties
Primary purpose	Equity compensation and incentive alignment	Enhance financing or investment transactions
Issuer	Usually granted under an employee or service provider equity plan	Usually issued by the company as part of a financing transaction
Exercise price	Often linked to fair market value at grant	Set by the warrant terms in the financing transaction
Vesting	Often subject to vesting conditions	Usually not tied to employment-style vesting
Dilution effect	Dilution typically linked to compensation plans	Dilution typically linked to financing transactions
Typical use case	Attracting, retaining, and incentivising talent	Supporting capital raising and investor participation

In practice, options are primarily used to align employee and adviser incentives, whereas warrants are more commonly used to support capital raising and investor participation.



11.0 Units/Fund Equity

What is Units/Fund Equity?

Units or fund equity represent proportional ownership in a pooled investment vehicle, such as a fund, trust, partnership, or ETF, rather than a direct ownership stake in a single operating company. Returns are linked to the performance of the vehicle's underlying assets, and governance, liquidity, and distribution rights depend on the specific structure.

Key Terms

Units or interests held

- The number of units or interests the investor owns in the vehicle, representing their proportional share of the fund or trust

Distributions

- Investors may receive income or profits through periodic distributions, depending on the vehicle's underlying assets and distribution policy

Liquidity / redemption

- Some fund interests can be traded or redeemed relatively easily, while others are locked up or subject to limited withdrawal rights

Management and fees

- Managers or trustees oversee the vehicle and may charge fees that reduce investor returns

Advantages	Disadvantages
Diversified exposure across multiple assets	Management fees reduce returns
Professional portfolio management	Limited control over underlying investment decisions
Access to assets that may be difficult to hold directly	Liquidity may be restricted depending on the structure
Potential for income and capital growth	Performance depends on manager quality

12.0 Key Takeaways

Although equity instruments vary widely, their use is ultimately shaped by how they allocate ownership, control, downside protection, and upside participation.

Rights and returns vary significantly across instruments:

Not all equity exposure is the same. Some instruments provide direct ownership and voting rights, while others emphasise economic priority, conversion features, or future upside.

Investor protection often comes at the cost of simplicity or flexibility

Instruments such as preferred stock and convertible notes can offer stronger investor protections, but they are usually more complex than common stock or SAFEs.

Timing matters in early-stage financing

Convertible notes and SAFE notes delay valuation until a later financing round, making them useful when the company is still difficult to price.

Incentive instruments differ from financing instruments

Stock options are generally used to attract, retain, and incentivise employees or advisers, whereas warrants are more commonly used to support financing transactions and investor participation.

Structure shapes control, liquidity, and payout outcomes

Whether an investor holds common shares, preferred shares, a convertible instrument, or fund units, the legal structure influences governance rights, liquidation priority, liquidity, and return potential.

Ultimately, the most suitable instrument depends on the company's stage, funding objectives, investor expectations, and the balance sought between control, protection, liquidity, and upside potential.

13.0 When Each Instrument Is Used

Different equity instruments are used for different commercial purposes depending on the company's stage, funding needs, investor expectations, and desired balance between control, protection, and upside.

Instrument	Typical Use	Common Holders	Key Benefit	Key Trade-off
Common Stock	Core ownership	Founders, employees, public investors	Full upside and voting rights	Ranks last in liquidation
Preferred Stock	Growth-stage equity financing	Institutional investors	Dividend and liquidation priority	Greater complexity; less upside than common
Convertible Notes	Early-stage bridge financing	Seed and early-stage investors	Faster fundraising with deferred valuation	Interest and maturity pressure
SAFE Notes	Very early-stage fundraising	Early investors	Simple; no interest or maturity date	Fewer protections and uncertain dilution
Stock Options	Equity compensation and incentive alignment	Employees, executives, advisers	Attracts and retains talent	Vesting, expiry, and dilution on exercise
Warrants	Financing incentive or deal sweetener	Investors, lenders, third parties	Added upside in financing deals	Dilution and exercise complexity
Units / Fund Equity	Pooled investment exposure	Fund and ETF investors	Diversification and professional management	Fees and limited control





Let's Talk About Your Valuation

Whether you're preparing for a capital raise, a licensing deal, a shareholder transaction, or a cross-border negotiation, Sherwood can help you understand, articulate, and defend your value.

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