

HOW MANAGEMENT SUFFERS IN DOWN-ROUND FINANCINGS

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Valuation is the single most important factor in analyzing a venture investment. With a low valuation, private companies give up a larger part of the company to raise the funds they need. The dreaded "down round" is the means by which such ownership dilution occurs. In a down round - generally defined as a follow on financing where the company is valued lower than it was previously - the company sells shares to the new investors more cheaply than in its previous round of financing, enabling the new investors to purchase more shares (and thus a larger stake in the company) for the same money.

To get an idea of the impact, let's consider a company that in 2006 raised \$5 million from a venture capitalist at a \$10 million post-money valuation. The VC owned 50 percent of the company, with the remaining 50 percent split between the founders and the shares reserved in the employee stock option pool. In 2007, the company goes out to the venture capital market looking for another \$5 million. At the same \$10 million valuation (now pre-money), a new investor's \$5 million would buy a third of the company. If the new investor gives the company only a \$5 million pre-money valuation, the value of the company is cut in half, and the new investor's \$5 million buys half the company. The founders' stake and stock option pool has been diluted from 50 percent to 25 percent. It's as if the previous \$5 million financing never happened, and the founders gave up half the company at that time for nothing.

What about the ownership interest of the VC shareholder? Simple mathematics dictates that the first round venture capitalist should suffer the same dilution as the founders. Chalk it up to punishment for previously overvaluing the company? Hardly. Anti-dilution protection, which typically is not given to management or other holders of the company's common stock, automatically increases on existing investor's stake in the company to offset some of the dilution experienced in a down round.

The two principal forms of anti-dilution protection are "weighted-average" and "full ratchet." While both serve to protect the investor from dilution by increasing the number of shares of common stock issuable upon conversion to preferred stock, a weighted-average formula is best from the startup's point of view. The weighted-average approach takes all stock outstanding prior to the issuance as if it were issued at the same price as the protected shares, then lowers the price at which the protected shares can be converted to common stock to the weighted average of the price of the new issuance and the outstanding shares' price.

The harshest anti-dilution protection from the perspective of the founders is the full ratchet. Much simpler than a weighted average analysis, under a full ratchet, the protected investors have their stake reconfigured to the new valuation. This is accomplished by dropping the conversion price of the protected shares to the price of the new, dilutive shares. For example, an investor who paid \$4 a share for a 10 percent stake would get more shares to maintain that stake if the next valuation resulted in a round at \$2 per share - picking up 2 shares for every \$4 share previously purchased. In sum, full ratchet anti-dilution protection allows an investor to have his percentage ownership remain the same as when the initial investment was made.



Anti-dilution protection is one of the most hotly negotiated terms in any venture financing. Venture capitalists usually demand - and often get - full ratchet protection. The result is that if the company raises its next round of capital at discounted valuation, the dilution suffered by the founders, early-stage investors and employees holding stock options will push them further down the food chain.

Founders and early-stage investors can minimize their dilution by raising only as much money as necessary at each stage of growth. But taking too little cash and running out is costly. Not only does continually tapping the venture capital market preoccupy management with selling stock as opposed to building and selling product, but returning to the venture capital well too often also suggests an inability to forecast. In addition, when the walls of the boardroom have closed in a little too far, payroll is looming, and market conditions get worse, companies will want as much money as they can get.

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