Improved Weighted-Average Anti-Dilution Terms for Early Stage Investments

Drew Hession-Kunz, MSF
Senior Lecturer, Finance Dept.
Boston College
hessiona@bc.edu
617-552-2799
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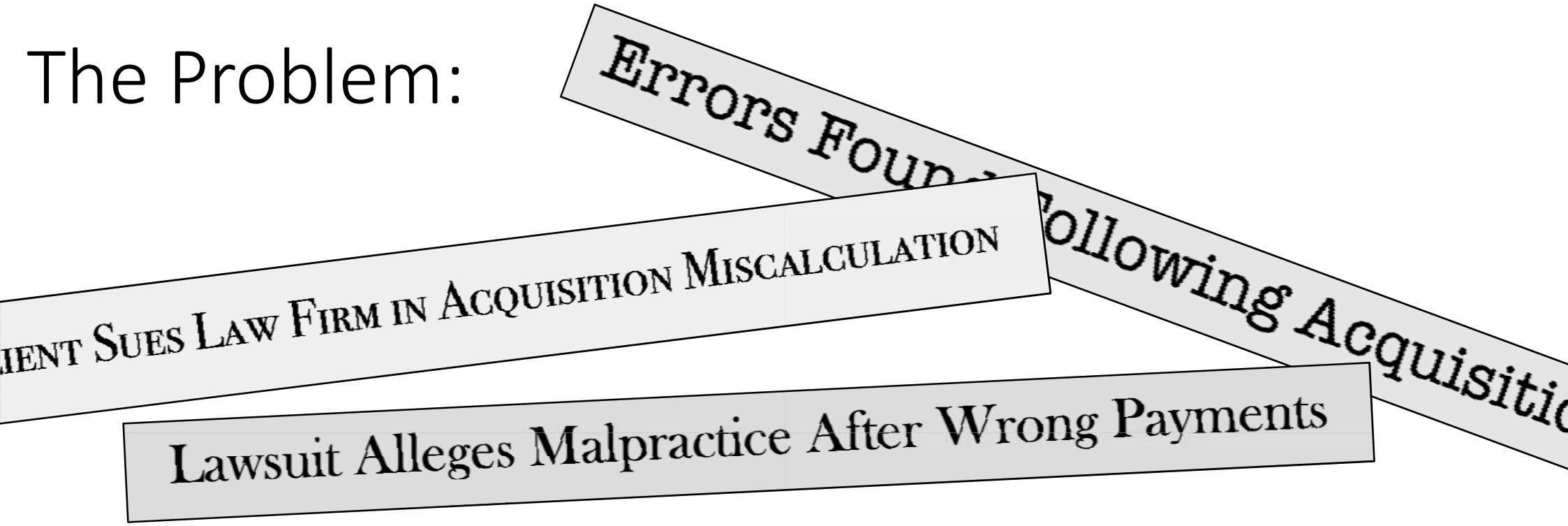
The Problem:



Early Stage Investors sometimes misprice early round investments

Anti-Dilution Protection is set up to correct early mispricing, but is error-prone and complex to implement

Abstract

- Early Stage Investors Purchase Preferred Equity
- Often overprice early rounds
- Difficult to value opaque ideas
- Difficult to value future market behavior
- Yet to invest, usually set a price on shares

Abstract - continued

- Early Stage Investors Purchase Preferred Equity
  - Often negotiated in: Anti-Dilution Protection
- Anti-Dilution Protection cannot return funds
- Instead, increases share ownership to re-price earlier investments

Abstract - continued

- Two Methods of calculating how many new shares to issue if “Down Round” hits
  - Full Ratchet
  - Weighted Average

Abstract - continued

- Weighted Average
  - Most common Anti-Dilution approach
  - Uses 7 (seven) variables, not directly available
  - Complex to calculate
    - Attorneys are not trained in math, yet must vouch for calculations
  - History of errors
  - Lawsuits and lost business often result

Abstract - continued

- Weighted Average Anti-Dilution – New
  - New method is simpler
  - Uses numbers always available at closing

What Is Anti-Dilution Protection?

What Is Anti-Dilution Protection?

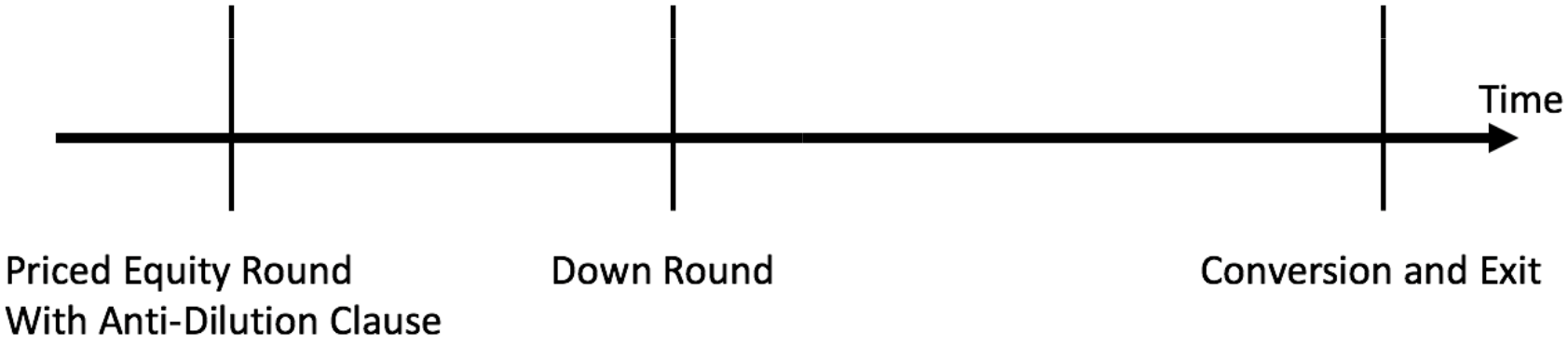
- A term negotiated into Preferred Equity in early stage investments
- Creates and distributes additional shares to investors IF:
  - Investors after them paid a LOWER PER SHARE PRICE
  - Conversion from Preferred to Common happens

What Risks Drive Anti-Dilution Protection?

- Technical Risk – difficult to accurately predict costs
- Market Risk - creation of a new market takes time

What Is Anti-Dilution Protection?

- Anti-Dilution Protection has three key dates:



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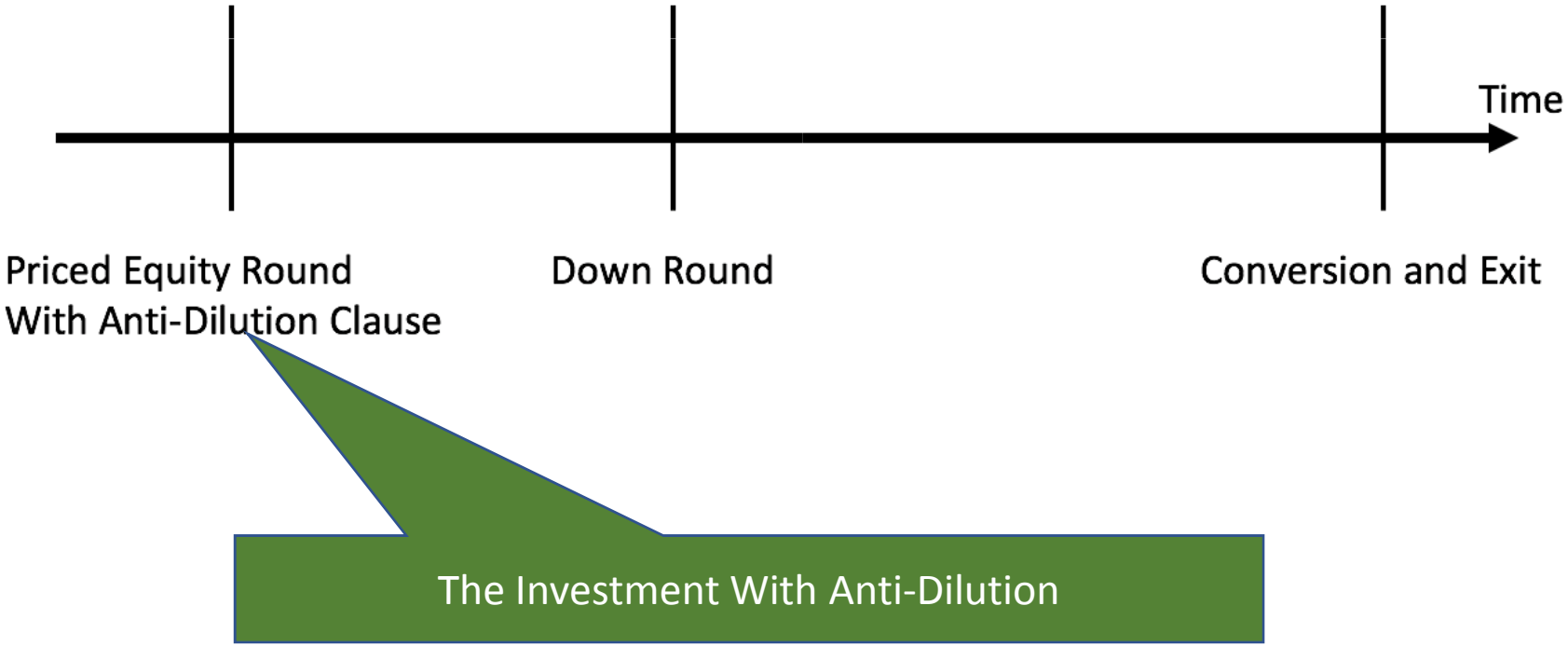

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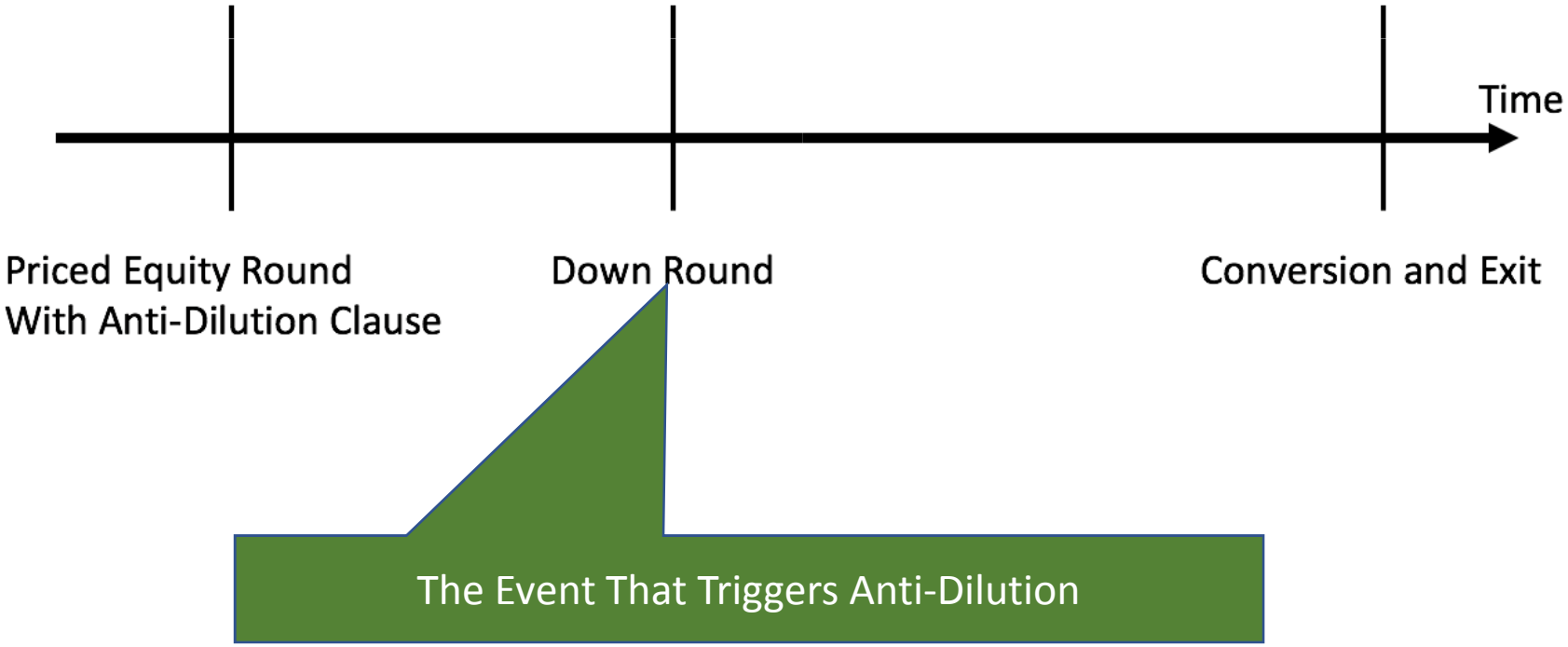

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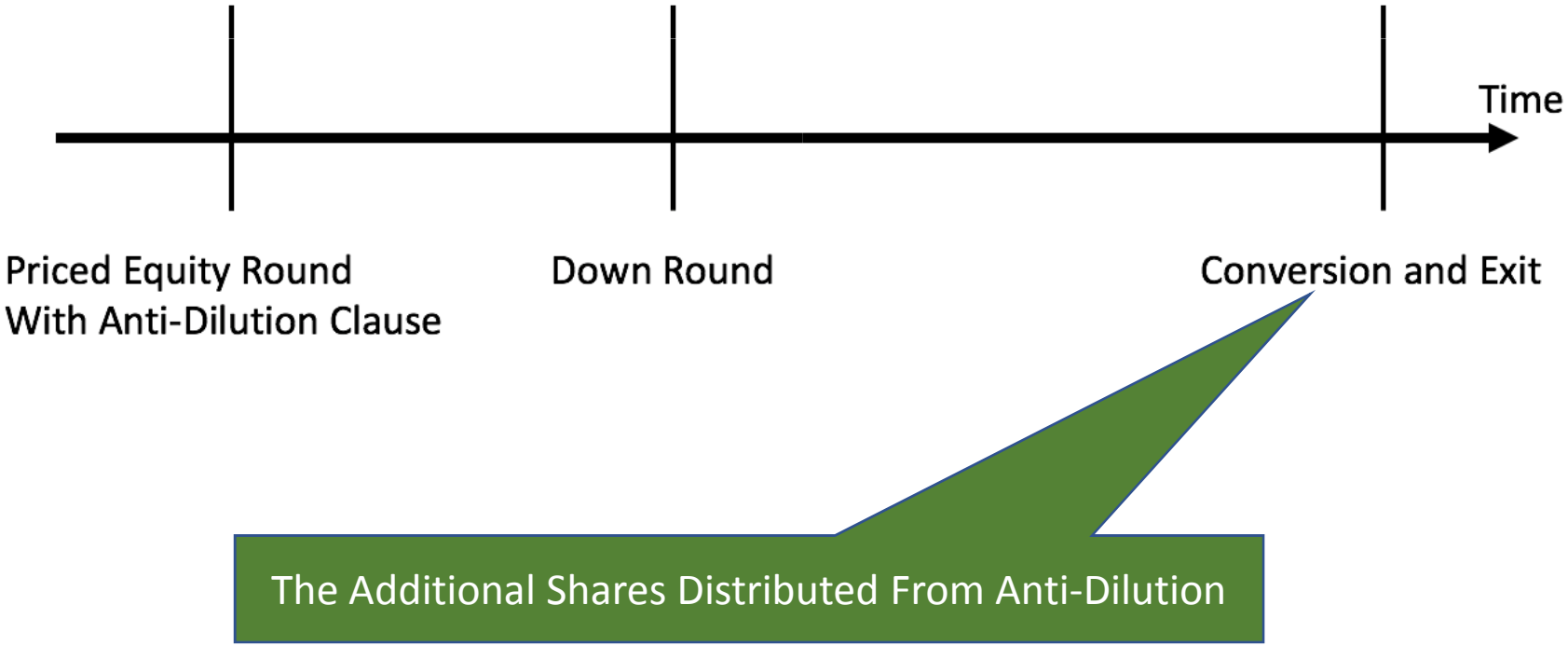


How is Anti-Dilution Protection Calculated?

- Two Methods of calculating how many new shares to issue if “Down Round” hits
  - Full Ratchet –
    - Old shares are re-priced when a new, lower price is transacted
  - Weighted Average –
    - Old shares are partially re-priced, based on a “weighted average” of quantity and price differential

Anti-Dilution – What Is It?

- **Full Ratchet**
  - Complete RE-PRICING of earlier investment
  - “Corrects” original price to new price
  - Easy to Calculate
  - Punitive and limiting
    - Includes options issued for hiring, board, bonuses
    - Limits ability to incentivize, manage

Full Ratchet Anti-Dilution: Formula

New Conversion Ratio = Old Price/New Price

…he can have it some other way. But
I don't think that he would like it.

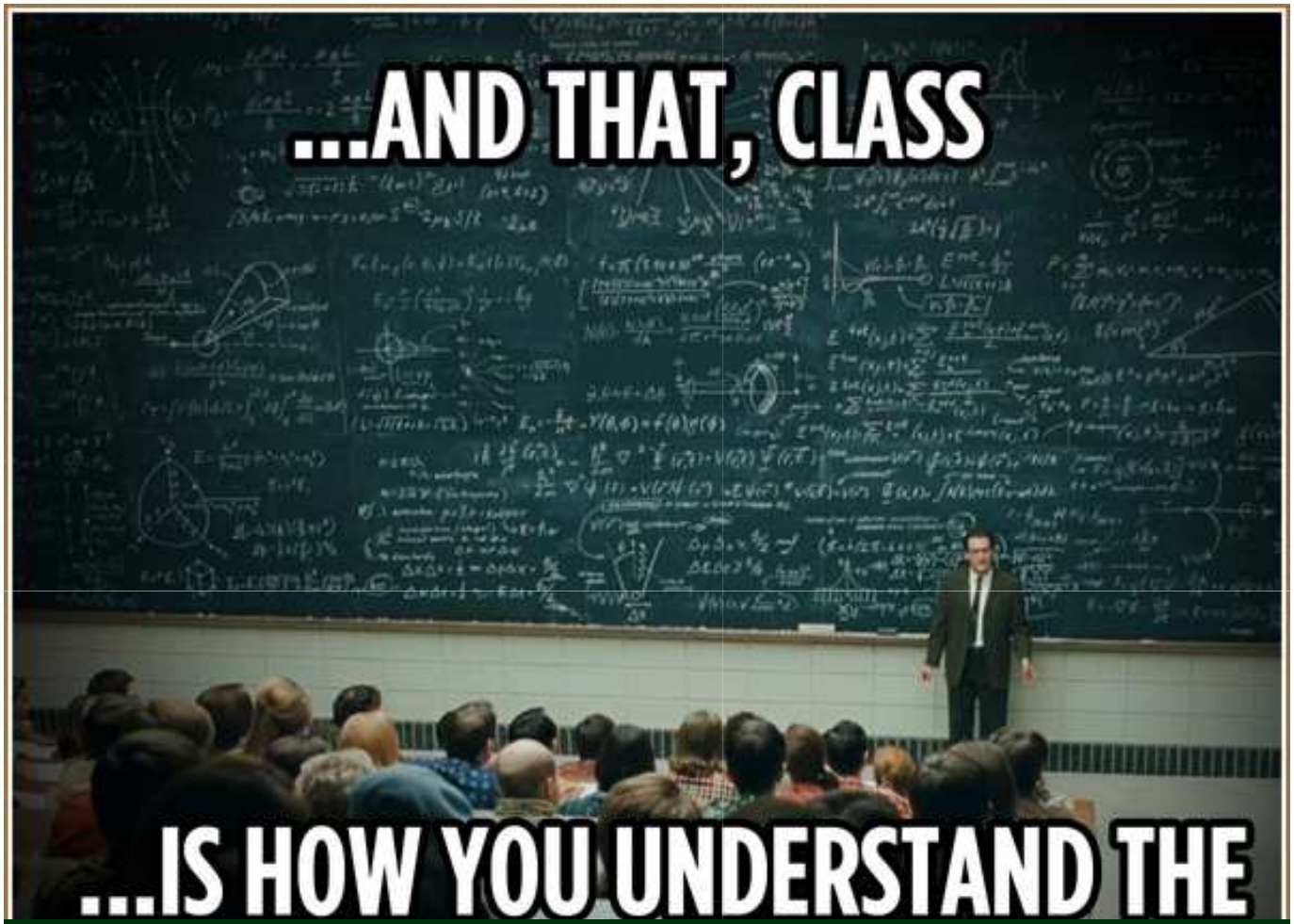
Anti-Dilution – What Is It?

- **Weighted Average Anti-Dilution**
  - Partial RE-PRICING of earlier investment
  - “Corrects” original price
    - Takes into account: Quantity, Price Differential
  - Most common Anti-Dilution approach

Weighted Average Anti-Dilution- Current Method

$CP_2 = CP_1 * (A+B) / (A+C)$

- CP_2 = Series A Conversion Price in effect immediately after new issue
- CP_1 = Series A Conversion Price in effect immediately prior to new issue
- A = Number of shares of Common Stock deemed to be outstanding immediately prior to new issue (includes all shares of outstanding common stock, all shares of outstanding preferred stock on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing)
- B = Aggregate consideration received by the Corporation with respect to the new issue divided by CP_1
- C = Number of shares of stock issued in the subject transaction. The "broadest" base would include shares reserved in the option pool.



Weighted Average Anti-Dilution Formula

Weighted Average Anti-Dilution – Proposed New Method

The NEW "New Conversion Ratio" formula:

$$1: \frac{\text{Total shares at completion of new round}}{\text{Total shares before new round} + (\text{New \$ in}/\text{Earlier Round Share Price})}$$

Reasoning

The NVCA Model Term Sheet, and the ultimate shareholder agreement flowing from Term Sheets built on that model, reference Anti-Dilution clauses as follows:

- “The Series A Preferred stock initially converts 1:1 to Common stock at any time at option of holder, subject to adjustments for stock dividends, splits, combinations and similar events and as described below under “Anti-Dilution Provisions.””

Reasoning

ISSUE:

The formula used calculates the New Conversion Price, but leaves unspecified the New Conversion Ratio- which is the key calculation in this process!

Reasoning

ISSUE:

To sort out the capitalization table, and commensurate ownership and payout at exit we have to calculate a Conversion Ratio, and how many new shares are to be created at the conversion/exit.

These additional steps are generally not identified or specified, and therefore are left ambiguous, meaning at the lawyer’s discretion.

Reasoning

SOLUTION:

This new method exactly specifies, using a simple transparent formula, **the distribution of cash** upon exit by acquisition.

Nothing is left ambiguous, nor at lawyer’s discretion.

Reasoning

SOLUTION:

Use the OLD formula, but carry it out fully to the

CONVERSION RATIO

Which is our target number; and

SIMPLIFY based on legal relationships between rounds of capital

WA Anti-Dilution – Formulation

1: (A+C)/(A+B)

A = # of shares of Common Stock immediately prior to new issue

B = $ raised in the new round divided by share price of the old round

C = # of shares issued in the down round

WA Anti-Dilution – Formulation

1: (A+C)/(A+B)

All of these numbers are directly available to all parties at the closing of an acquisition:

A = # of shares of Common Stock immediately prior to new issue
B = $ raised in the new round divided by share price of the old round
C = # of shares issued in the down round

Weighted Average (WA) Anti-Dilution – Example

An A round investor buys a third of the company for $2 million. They receive 1 million shares of A Round Preferred stock at $2 per share. 15 months later the company has a down round, selling 500,000 shares in exchange for $500,000.

IF the investor has Weighted Average Anti-Dilution protection on their A Round shares, how many new shares do they receive upon exit?

WA Anti-Dilution – Example continued

LET'S CALCULATE THE BASICS FIRST:

An A round investor buys a third of the company for $2 million,

NOTE: making an imputed post-money valuation of $6 million.

They receive 1 million shares of A Round Preferred stock at $2 per share,

NOTE: making an imputed total companywide shareholding of 3 million.

15 months later the company has a down round, selling 500,000 shares in exchange for $500,000,

NOTE: imputed at $1 per share.

WA Anti-Dilution – Example continued

WHAT DOES OUR CAP TABLE LOOK LIKE:

	Upon Founding	Post A Round	Post B Round	At Exit
Founders	2,000,000	2,000,000	2,000,000	2,000,000
A Round Investors	-	1,000,000	1,000,000	???
B Round Investors	-	-	500,000	500,000

WA Anti-Dilution – Example continued

LET'S CALCULATE THE CONVERSION RATIO:

Weighted Average New Conversion RATIO Calculation:

1: (A+C)/(A+B)

A = # of shares of Common Stock immediately prior to new issue
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WA Anti-Dilution – Example continued

LET'S CALCULATE THE CONVERSION RATIO:

Weighted Average New Conversion RATIO Calculation:

1: (A+C)/(A+B)

From our Cap Table:

A = # of shares of Common Stock immediately prior to new issue – 3,000,000
B = $ raised in the new round divided by share price of the old round – 250,000
C = # of shares issued in the down round – 500,000

WA Anti-Dilution – Example continued

LET'S CALCULATE THE CONVERSION RATIO:

Weighted Average New Conversion RATIO Calculation:

1: (A+C)/(A+B)

Therefore:

1: (A+C)/(A+B) = (3,000,000+500,000)/(3,000,000+250,000)

1: 1.076923

WA Anti-Dilution – Example

Let's Complete Our Cap Table:

	Upon Founding	Post A Round	Post B Round	At Exit
Founders	2,000,000	2,000,000	2,000,000	2,000,000
A Round Investors	-	1,000,000	1,000,000	1,076,923
B Round Investors	-	-	500,000	500,000

Summary

- Investors in Early Stage companies need a reliable way to protect against mispricing of early rounds, as evidenced by later “Down Rounds”
- Current methods of calculating the outcomes of Anti-Dilution clauses often lead to errors
- The new proposed method calculates all the way to Conversion
- The new proposed method reduces potential for errors

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