

The Price of Growth

The Lifecycle of a Company from a Founder's Dilution Perspective

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Founders of a company considering the various fundraising options available often ask the following challenging question: Why should they take venture capital money, which may significantly dilute the founders' equity and result in the founders' loss of control of the company? Although the venture capital path is always a possibility, founders are often concerned about the consequences of such investments and ask whether the money is worth the risk.

There are many benefits to obtaining venture capital financing, including:

- immediate access to a significant amount of capital
- a strong likelihood that the investors will have funds reserved for future rounds of financing
- access to the investors' expertise, experience and network
- immediate credibility in the marketplace from a customer perspective
- ability to hire key employees with the increased credibility in the job market
- ability to ramp up the company quickly and beat the competition to the market.

Assuming the founders have determined that the benefits of venture capital financing outweigh the risks, the founders must expect, appreciate and understand the dilutive effect of multiple rounds of venture capital financings. This article considers the consequences of accepting venture capital financing from the perspective of equity dilution and reviews the dilutive effective of multiple rounds of venture capital financing under various scenarios.

The Series A Round

Perhaps the most highly negotiated business term for a venture capital financing is the pre-money valuation established for the company (the "post-money" valuation will equal the pre-money valuation plus the amount invested in the company by the venture capitalists). A lower than anticipated valuation is often a challenging issue for founders to overcome as it can be difficult for founders to look long-term and appreciate the potential benefit of owning a small percentage of a very successful company as opposed to a large percentage of an unsuccessful company. However, often the difference between failure and success is a company's ability to get to the market quickly. In order to do so, companies need access to capital to hire employees. Taking venture capital money can provide founders with access to that capital as well as access to additional funds reserved by the vcs for later rounds of funding for their portfolio companies.

For the sake of this article, let's assume a pre-money valuation of \$4,000,000 for a company undergoing its first round of venture capital financing. If the investors were to commit

\$4,000,000, these amounts would result in a post-money valuation of \$8,000,000 and the investors would receive 50% of the company on a fully-diluted basis. In this scenario, founders often assume that the founders would therefore own the remaining 50% of the company post-closing. However, depending upon the current composition of the management team (and current stock positions of each member), the investors will typically expect a stock option pool to be implemented immediately prior to closing to reserve stock for future issuances to new hires, allowing the company to round out the management team. This option pool is usually established prior to closing so that the investors are not diluted. Although the size of the option pool is a subject of negotiation, a typical option pool might reserve 20% of the stock of a company on a fully-diluted basis. Therefore, in the above example, instead of the founders owning 50% of the stock after the Series A closing, the founders would instead own only 30% of the equity on a fully-diluted basis (with the investors owning 50% and 20% reserved for the stock option pool).

Another significant business term often negotiated with the initial round of venture capital financing is the vesting of the founders' equity. The above example states that the founders own 30% of the stock on a fully-diluted basis. However, this percentage assumes that all of the founders' stock is vested. Although the specific vesting terms can be negotiated, most investors will require that founders' stock vest over a period of time (often over four years). To the extent a founder leaves the company, the company will have the right to repurchase the unvested shares from the founder at a nominal price (typically the price at which the founder purchased the shares). If founders have contributed significant "sweat" equity and have been employed by the company for some time prior to the investment by the vcs, the investors may agree to vest some of the founders' shares upfront and effectively give the founders "credit" for their past efforts. The investors may also agree to accelerate the vesting of a portion or all of the shares upon a change of control or if a founder is terminated by the company without cause prior to a change of control.

Based upon the above example, after the Series A round of financing, the equity distribution can be summarized as follows:

Founders	100%	30%
Series A Investors		50%
Option Pool		20%
Group	Pre-Series A	Post-Series A
Founders	100%	30%
Series A Investors		50%
Option Pool		20%

Series B Round

When a company raises a Series A round, the investors will want to know how long the company will be able to operate using the raised money before requiring additional capital. The answer of course depends upon the amount raised and several other factors, but the period is usually between 12 - 18 months. The Series A round is often closed prior to a company having any revenue or entering into contracts with third parties to sell its products or services. As a company matures and moves towards a Series B financing, the expectation is that the valuation of the company will increase over time. In the prior example, the post-money valuation of the company was \$8,000,000. To the extent a company can attract a new lead investor for a Series B round and is achieving its targets, the company will likely be able to obtain a better valuation.

Let's assume for purposes of this article that the Series B pre-money valuation is \$12,000,000 with a \$6,000,000 investment, resulting in a post-money valuation of \$18,000,000. The Series B investors will then own 33 1/3% of the company, and the founders would be diluted to approximately 20% of the company on a fully-diluted basis. Depending on the status of recent hires with the company, in many instances a new lead investor would require that additional

equity be reserved to increase the option pool (which will result in dilution to the founders and the Series A investors). This discussion assumes that the option pool has not been further increased.

After the Series B financing, the equity distribution on a fully-diluted basis can be summarized as follows:

Group	Pre-Series A	Post-Series A	Post-Series B
Founders	100%	30%	20%
Series A Investors		50%	33 1/3%
Series B Investors			33 1/3%
Option Pool		20%	13 1/3%
Total:	100%	100%	100%

Series C Round

Assuming the company continues to progress positively, it may seek a third round of financing, often within 18 – 24 months of the Series B closing. In many instances, however, companies fail to achieve targeted revenue or other goals established or fail to achieve a financial budget, resulting in what is known as a “down round” pursuant to which the pre-money valuation in a new round is less than the post-money valuation from the prior round. If a “down round” occurs, then the Series A investors and Series B investors may be entitled to anti-dilution protection, which will increase the number of shares of common stock into which the preferred stock converts (thereby further diluting the founders).

In some instances, the new Series C investors will require the prior investors to waive anti-dilution rights. In our example, if we assumed an up-round with an increased pre-money valuation to \$30,000,000 and an investment amount of \$10,000,000, then the resulting post-money valuation will equal \$40,000,000. Without an increase in the option pool, the new investors will own 25% of the company, and the founders will now be diluted to 15% of the company on a fully-diluted basis.

After the Series C closing, the company has now raised a total of \$20,000,000. The investors, in the aggregate, hold 75% of the company, the founders own 15% of the company, and the option pool (vested and unvested granted options as well as shares reserved for future issuances) represents 10% of the company on a fully-diluted basis. The capital structure now looks like:

Group	Pre-Series A	Post-Series A	Post-Series B	Post-Series C
Founders	100%	30%	20%	15%
Series A Investors		50%	33 1/3%	25%
Series B Investors			33 1/3%	25%
Series C Investors				25%
Option Pool		20%	13 1/3%	10%
Total:	100%	100%	100%	100%

Liquidity Events

How the consideration on an acquisition is divided among equity holders can vary significantly depending upon the terms of the preferred stock. In the above scenario in which a company has raised \$20,000,000 of venture capital financing, let’s examine the following three different potential outcomes: a sale with net proceeds to stockholders of \$25,000,000, a sale of \$50,000,000 and a sale of \$100,000,000. The analysis below assumes that all debt, investment banking fees, legal fees and other obligations of the company which must be paid at closing prior to any distributions to stockholders have been paid and are not included in these amounts.

\$25,000,000 Sale

Many companies eventually run out of internal investor support and have difficulty raising additional capital from new lead investors. One common path in this situation is a sale of the company if the company is not yet cash-flow positive and is not capable of raising more money. If a company has raised \$20,000,000, a \$25,000,000 sale will not leave much for the founders as holders of common stock. Preferred stock terms will in almost all instances include a liquidation preference provision, which will allow the holders of preferred stock to receive their investment back first before any cash is distributed to the holders of common stock.

In this example, therefore, the first \$20,000,000 will be distributed to the investors because of their liquidation preferences. How the remaining \$5,000,000 is allocated will depend upon several factors, including whether the preferred stock is “participating” – i.e., whether the holders of preferred stock receive their money back first and also are allowed to participate on an as converted basis in the distribution of the remaining amount or whether the holders of preferred stock only receive the greater of their money back or the amount they would have received had they converted to common stock immediately prior to the transaction.

If the preferred stock is participating, then upon a \$25,000,000 sale, the investors would receive \$20,000,000 plus \$3,750,000 (75% of the remaining \$5,000,000) for a total of \$23,375,000, leaving the founders with \$750,000 (15% of the remaining \$5,000,000) and the option holders with \$500,000 (10% of the remaining \$5,000,000, assuming all options are vested and for simplicity purposes disregarding the exercise price of the options). If the preferred is not participating, then the investors would receive \$20,500,000 (the Series B and Series C would elect to receive their initial investment back but the Series A would be treated on an as converted basis to receive \$4,500,000), the founders would receive \$2,700,000 and the option holders would receive \$1,800,000.

Another factor which could significantly impact the distribution of proceeds on the sale of a company is whether the holders of preferred stock have rights to dividends. Cumulative dividends paid out upon a liquidity event could significantly increase the amount distributed to the holders of preferred stock. If cumulative dividends were included in this company with an 8% annual return over 4 years for the Series A, 3 years for the Series B and 2 years for the Series C, then the dividends would increase the preference amounts payable to the preferred stock to \$5,280,000 for the Series A, \$7,440,000 for the Series B and \$11,600,000 for the Series C.

If the preferred stock is also participating, then on a sale of the company with \$25,000,000 to be distributed to stockholders, the holders of preferred stock would receive a total of \$24,830,000 (\$24,320,000 for the preferences and another \$510,000, which represents 75% of the remaining \$680,000). In this scenario, only \$102,000 would be distributed to the founders (15% of \$680,000) and only \$68,000 would be distributed to option holders (10% of \$680,000). Alternatively, with cumulative dividends but no participating feature, the holders of preferred stock would receive \$24,320,000, the founders would receive \$408,000 (60% of the remaining \$680,000) and the option holders would receive \$272,000 (40% of the remaining \$680,000).

\$50,000,000 Sale

As we increase the proceeds of a transaction to \$50,000,000, the amount to be distributed to common stockholders increases significantly and will continue to depend, among other things, upon whether the preferred is participating and whether the preferred terms include dividends. If the preferred is participating (with no dividend), then the investors would receive \$20,000,000 plus \$22,500,000 (75% of the remaining \$30,000,000) for a total of \$42,500,000, leaving the founders with \$4,500,000 (15% of the remaining \$7,500,000) and the option holders with \$3,000,000 (10% of the remaining \$30,000,000 and assuming all options are vested and for simplicity purposes disregarding the exercise price of the options). If the preferred is not participating, then, given the amount the investors would receive had they just converted to common stock immediately prior to the transaction, the investors would instead elect to receive

their percentage on a fully-diluted basis, with the investors receiving in the aggregate \$37,500,000 (75% of \$50,000,000), the founders receiving \$7,500,000 (15% of \$50,000,000) and the option holders receiving \$5,000,000 (10% of \$50,000,000).

If 8% cumulative dividends were included (again assuming 4 years for Series A, 3 years for Series B and 2 years for Series C), then the dividends would again increase the preference amounts payable to the preferred stock. If the preferred stock is participating, then on a sale of the company with \$50,000,000 to be distributed to stockholders, the holders of preferred stock would receive a total of \$43,580,000 (\$24,320,000 for the preferences and an additional \$19,260,000, which represents 75% of the remaining \$25,680,000). In this scenario, only \$3,852,000 would be distributed to the founders (15% of \$25,680,000) and only \$2,568,000 would be distributed to option holders (10% of \$25,680,000). Alternatively, with cumulative dividends but no participating feature, the breakdown would be identical to the scenario above in which there were no dividends and no participating feature, with the investors receiving in the aggregate \$37,500,000 (75% of \$50,000,000), the founders receiving \$7,500,000 (15% of \$50,000,000) and the option holders receiving \$5,000,000 (10% of \$50,000,000).

\$100,000,000 Sale

As we increase the proceeds of a transaction to \$100,000,000, the amount to be distributed to common stockholders continues to increase significantly. If the preferred is participating (with no dividend), then the investors would receive \$20,000,000 plus \$60,000,000 (75% of the remaining \$80,000,000) for a total of \$80,000,000, leaving the founders with \$12,000,000 (15% of the remaining \$80,000,000) and the option holders with \$8,000,000 (10% of the remaining \$80,000,000 and assuming all options are vested and for simplicity purposes disregarding the exercise price of the options). If the preferred is not participating, then, given the amount the investors would receive had they just converted to common stock immediately prior to the transaction, the investors would instead elect to receive their percentage on a fully-diluted basis, with the investors receiving in the aggregate \$75,000,000 (75% of \$100,000,000), the founders receiving \$15,000,000 (15% of \$100,000,000) and the option holders receiving \$10,000,000 (10% of \$100,000,000).

If 8% cumulative dividends were included with the same assumptions as above, then the dividends would again increase the preference amounts payable to the preferred stock. If the preferred stock is participating, then on a sale of the company with \$100,000,000 to be distributed to stockholders, the holders of preferred stock would receive a total of \$81,080,000 (\$24,320,000 for the preferences and another \$56,760,000, which represents 75% of the remaining \$75,680,000). In this scenario, only \$11,352,000 would be distributed to the founders (15% of \$75,680,000) and only \$7,568,000 would be distributed to option holders (10% of \$75,680,000). Alternatively, with cumulative dividends but no participating feature, the breakdown would be identical to the scenario above in which there were no dividends and no participating feature, with the investors receiving in the aggregate \$75,000,000 (75% of \$100,000,000), the founders receiving \$15,000,000 (15% of \$100,000,000) and the option holders receiving \$10,000,000 (10% of \$100,000,000).

A Founder's Conclusion

How can these numbers and calculations assist founders in their negotiations with investors? The above figures clearly show the economic significance and impact of the preferred stock terms. Having a participating preferred stock feature will in most instances provide more cash to the investors upon a sale of the company and reduce the amounts to be paid to the founders. Although this feature was once quite prevalent, in recent years it has become less common and founders often are able to negotiate this term out of the deal (or at least negotiate a cap on the liquidation preference, which the above scenarios for simplicity purposes do not contemplate).

The main argument for removing the participating preferred feature is that with a successful exit (such as the \$100,000,000 example above), it seems unreasonable to the founders that the

investors should still retain the participation feature since the investors will have a very successful return on their capital without it (6.25X for Series A in 4 years, 4.16X for Series B in 3 years and 2.5X for Series C in 2 years). Taking into account dividends will even further impact the outcome for founders. For example, in the above \$50,000,000 scenario, the distribution to the founders almost doubles (from \$3,852,000 to \$7,500,000) if the preferred stock is not participating and does not include dividends.

Founders should therefore always remember to weigh the importance of these economic terms and the many benefits of obtaining venture capital financing against other alternative financing arrangements which may be available to the company.

For more information on merger and acquisition issues, please contact **Mary Beth Kerrigan**.