TOPE ADEBAYO LP

EQUITY DILUTION: WHAT FOUNDERS AND EARLY INVESTORS NEED TO KNOW

Equity Dilution: What Founders And Early Investors Need To Know

As startups grow and seek funding, understanding equity dilution is crucial for both founders and early investors. Balancing immediate funding needs with the goal of maximizing share value is key to driving sustainable growth and success for startups

What is Equity Dilution?

Equity dilution happens when a company issues new shares, reducing the ownership percentage of existing shareholders. This often occurs during funding rounds or capital raises to secure capital for growth, product development, or expansion. While essential for growth, equity dilution significantly impacts founders and early investors.

Implications for Founders and Early Investors

For most tech startups, equity dilution is inevitable. Ideally, dilution should coincide with a higher company valuation so that the actual value of the investment remains the same or increases. To better appreciate this, let us consider the dilution impact of a subsequent fundraising at a higher and lower valuation in a scenario where a startup is initially valued at $100,000 with 100,000 units of shares and investor A holds 10% of the startup ($10,000/ 10,000 units of shares).

Description	Higher Valuation Scenario	Lower Valuation Scenario
Pre-money valuation[1]	$150,000	$90,000
Additional fund raised	$50,000	$50,000
Price per share	$1.5 $\left(\frac{\$150,000}{100,000}\right)$	$0.9 $\left(\frac{\$90,000}{100,000}\right)$
Number of shares issued to new investors	33,333 units $\left(\frac{\$50,000}{\$1.5}\right)$	55,556 units $\left(\frac{\$50,000}{\$0.9}\right)$
Total issued shares post-money	133,333 units (100,000 + 33,333)	155,556 units (100,000 + 55,556)
Post-money valuation[2]	$200,000 ($150,000 +$50,000)	$140,000 ($90,000 +$50,000)
Investor A's stake post-money (%)	7.5% $\left(\frac{10,000 \ \text{X}\ 100}{133,333}\right)$	6.4% $\left(\frac{10,000 \ \text{X}\ 100}{155,556}\right)$
Value of Investor A's stake post-money	$15,000 (10,000 X 1.5)	$9,000 (10,000 X0.9)

[1]Pre-money valuation refers to the value of a company before it receives any new capital investment.
[2]Post-money valuation is the value of a company after it has received new capital investment. This valuation includes the company's pre-money valuation plus the new capital that has been invested.

The above scenario illustrates how subsequent fundraising at different valuations impacts the ownership percentage of existing investors. Higher valuations generally result in less dilution, while lower valuations cause more significant dilution. Each new funding round can worsen this effect of dilution, so it's vital to plan strategically for your company's long-term capital needs. Balancing immediate funding needs with the goal of maximizing share value is key to driving sustainable growth and success for startups.

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STRATEGIES TO MITIGATE EQUITY DILUTION

a. Raise What You Need

Early-stage funding is the most expensive money you'll ever raise. At this point, your startup has higher risks, no viable assets, and no guarantee of profitability. To compensate for these risks, early investors often invest at reduced valuations with terms that protect them against future down rounds.[3] This makes early funding particularly costly. It is crucial to understand the current financial need of the company to protect your ownership by not raising more than the required amount. Over-raising can result in giving away a significant portion of your company while under-raising puts your company at risk of running out of cash before achieving key milestones."

By carefully balancing your immediate funding needs with long-term goals, you can retain more control, guide your startup toward achieving higher metrics, and seek additional funding with stronger negotiating power and valuation.

b. Mastering Convertible Notes and Simple Agreements for Future Equity (SAFEs)

Convertible notes and SAFEs offer a way to raise funds without needing to determine the current valuation of your company. However, investors usually insist on including terms like discounts and caps to offset the increased risk inherent in these Agreements. Founders and early investors need to pay attention to these terms.

[3] A down round occurs when a company's valuation is lower than in previous funding rounds.

A discount allows investors to convert their investment at a predetermined percentage (usually between 10% and 25%) less than the actual price per share during a future financing round. Caps, on the other hand, help investors optimize their return on investment if the company exceeds set expectations or metrics. This is achieved by setting the maximum valuation and price per share at which the investment will be converted to equity. As the valuation of a company increases, the price per share also increases[4] thereby reducing the number of shares an investor is entitled to after conversion.

To illustrate, let's consider a company with 1,000,000 units of ordinary shares and a $200,000 convertible note converting at a qualified financing round valued at $10,000,000.

With a $5,000,000 valuation cap, the investor would receive up to two times more shares compared to a scenario without a cap. Here's a breakdown:

Cap	With a $5,000,000 Cap	Without Cap
Price per share	$\frac{\$5,000,000}{1,000,000}$ = **$5 per share**	$\frac{\$10,000,000}{1,000,000}$ = **$10 per share**
Total shares issued to the investor	$\frac{\$200,000}{\$5}$ = **80,000 Units of shares**	$\frac{\$200,000}{\$5}$ = **80,000 Units of shares**

I. An agreed discount on the price per share at a qualified financing round which is typically a priced round of equity funding beyond a certain threshold, or

ii. the price per share using the valuation cap that is the $\left(\frac{\textbf{pre-agreed valuation cap}}{\textbf{fully diluted capitalization}}\right)$[5]

The ideal situation for founders is for the convertible note to be uncapped but discounted. This rewards the convertible note investor for their early risk while avoiding the challenge of assigning an arbitrary value to the company. However, this can be a tough sell for investors because it limits their first mover's advantage. The alternative will be to negotiate a valuation cap that is close enough (using the negotiated discount as a margin) to the realistic value of the company at the next funding round. This approach balances investor protection with fair terms for the company.

> ***If a company starts a funding round prematurely it can result in a down round, leading to higher dilution and reduced value for early investors."***

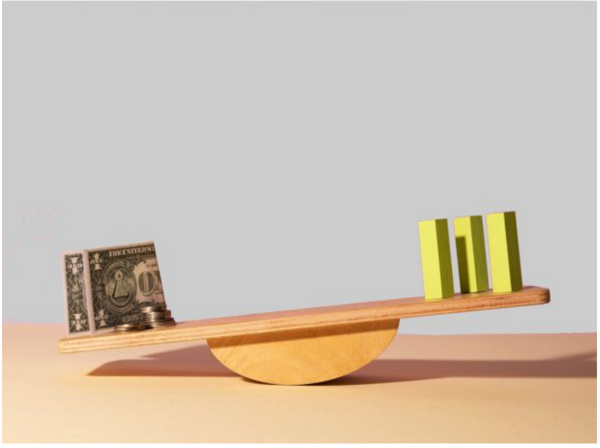
[4]This is based on the assumption the number of the Company's issued and outstanding shares remains constant.
[5]A fully diluted capitalization is the sum total of all issued and outstanding stock of the Company assuming the conversion, exercise, and/or vesting of all options, warrants, and any shares reserved for the Company's Employee Incentive Plan.

c. **Thread lightly with Warrants**

Warrants give investors the right, but not the obligation, to buy shares at a specific (usually highly discounted) price in the future, providing additional potential upside. While warrants can be standalone investment documents, investors may include warrants (particularly penny warrants) in convertible notes or SAFEs as sweeteners. Penny warrants allow investors to purchase additional shares at a nominal price (often $0.01) within a set exercise period.

Some investors may request penny warrants in addition to valuation caps and discounts, effectively asking for a multi-layered discount. For example, an investor might secure a 20% discount, a low valuation cap, and an option to acquire additional shares at a nominal price. This can lead to significant dilution for founders and early investors (after all discounts are applied). It's crucial for founders and early investors to fully understand the implications of these terms. Running the numbers to determine the worst-case scenario (i.e., if discounts and warrants are applied) can help in making informed decisions and negotiating fair terms.

d. **Avoiding Strict and Unrealistic Timelines for Maturity[6] and Qualified Financing Rounds**



A convertible note is designed to convert at a qualified financing round before the maturity date.[7] Investors, eager for a quick return and to motivate founders to achieve certain milestones rapidly, often include terms that provides alternative options and remedies if the company fails to secure a qualified financing round before the maturity date. These measures, are usually at the election of the investor and may include;

a. Immediate loan repayment with accrued interest.
b. Maturity conversion where the investment is converted to equity at a much lower valuation.
c. An option to participate during a non-qualified financing round with a higher discount on share price.
d. a right to a pre-agreed number of penny warrants.

Therefore, a short and definitive maturity date or deadline for a qualified financing round can lead to liquidity challenges or excessive dilution for existing investors. It also increases the

[6]This is the date when the loan and accrued interest under a convertible note must be repaid or converted into shares.
[7]For example, liquidation, change of control, acquisition, merger, or an event of default.

pressure on the Company to raise funds quickly. If a company starts a funding round prematurely[8] it can result in a down round, leading to higher dilution and reduced value for early investors.

When negotiating convertible notes, it is crucial to avoid setting strict and unrealistic timelines for maturity or qualified financing rounds. Instead, aim for timelines that are long enough to allow the company's valuation to significantly increase, and flexible enough to accommodate extensions if necessary to better position the company for the next funding round. By maintaining flexibility in timelines, founders can avoid these pitfalls and ensure they raise funds in subsequent fundraising rounds from a position of strength rather than weakness.

e. Negotiate Anti-Dilution Provisions

In simple terms, anti-dilution provisions act like protective shields for investors against the risk of a down round. These provisions come in two main types: Full ratchet and broad-based weighted average. Full ratchet anti-dilution provision is like a sharp sword. It slashes the price at which the investor purchased its shares in a previous round to match the lowest price of shares in a subsequent round if the price drops. For instance, if an investor bought a share for $10 and new shares are issued at $5 each, with a full ratchet, the investor's original share price would also drop to $5 and additional shares will be issued to the investor to ensure its investment value is not reduced.

On the other hand, broad-based weighted average anti-dilution provision is more like a balancing scale. It adjusts the conversion price based on both old and new share prices, averaging them out. So, if new shares are issued at a lower price, it doesn't hurt existing shareholders as much as a full ratchet would.

Founders and existing investors usually prefer broad-based weighted average anti-dilution provisions because they soften the blow of dilution. Though a bit more complex, they offer a fairer approach by spreading the impact across all shareholders.

f. Consider Alternative Financing

In many cases, the cost of equity outweighs the cost of debt. However, tech startups frequently don't meet the security requirements for traditional

[8] I.e., before meeting certain metrics and milestones resulting in a low company valuation and reduced negotiating power.

loans, lacking tangible assets. Despite this, they can explore alternative financing avenues such as grants, revenue-based financing, invoice discounting, or procurement finance, especially for asset acquisition. It is crucial to note that non-dilutive capital sources can impact future liquidity, so it's essential to consider their implications carefully. This approach can allow a company to scale without diluting ownership.

"You may consider optimizing your equity incentive pool and ensuring long-term commitment through strategies like not allocating a large portion of your equity incentive pool too early (if necessary, you can do additional allocations to employees subsequently), having a cliff period (typically one year), or vesting periods (typically four years) over which the allocated equity will vest in installments."

g. Optimizing Employee Equity Incentive Plan

Implementing equity incentive plans can align the interests of employees with the company's growth, ensuring everyone works towards increasing the overall value of the Company. Equity incentive pools typically range from 5% to 20%. Some companies increase the pool as they grow (usually to accommodate new executives or employees). However, while motivating and rewarding employ-

ees is important, it's equally critical to consider the impact on existing shareholders when the equity incentive pool is fully allotted to employees. You may consider optimizing your equity incentive pool and ensuring long-term commitment through strategies like not allocating a large portion of your equity incentive pool too early (if necessary, you can do additional allocations to employees subsequently), having a cliff period (typically one year), or vesting periods (typically four years) over which the allocated equity will vest in installments.

By carefully managing and optimizing the designated equity incentive pool, founders can maintain a healthy balance between incentivizing employees and protecting the interests of investors.

h. Negotiate a Founder(s) Equity Compensation Package

Negotiating an equity compensation package tied to performance can be a powerful anti-dilution strategy for founders. This gives founders an opportunity to regain part of their ownership

stake in the event they achieve or exceed certain audacious and unrealistically high milestones and metrics. Elon Musk applied this strategy with Tesla by negotiating a performance-based equity compensation package which gives him an opportunity to regain about 10% stake in Tesla if the company meets specific milestones and market capitalization targets.[9]

This method can be particularly effective in high-growth startups. By tying substantial equity compensation to performance, founders are motivated to go above and beyond to achieve audacious goals and valuation quickly. If the company achieves its targets and increases in value, the dilution impact is offset by the overall growth in share value, benefiting both the founders and investors.

To avoid the legal challenges in enforcing a founder's equity compensation package, like those Elon Musk has faced, it is crucial to secure formal approval from existing and new shareholders. This ensures transparency and consensus, fostering trust and aligning everyone's interests.[10]

CONCLUSION

Understanding and effectively managing equity dilution is paramount for founders to maintain control and maximize long-term value. Giving away a substantial portion of the company before even reaching Series A funding can prove detrimental, ultimately diminishing the rewards for founders and early investors in the long run. By grasping the factors and investment terms that influence dilution, founders and early investors can adeptly navigate the intricacies of funding, safeguard their interests, and propel the startup toward success.

[9] Tesla Investor Relations. (2018, January 23). Tesla Announces New Long-Term Performance Award for Elon Musk. https://ir.tesla.com/press-release/tesla-announces-new-long-term-performance-award-elon-musk. Accessed 21st June 2024.
[10] Hals, T. (2024, January 31). Judge voids Elon Musk's 'unfathomable' $56 billion Tesla pay package. Reuters. https://www.reuters.com/legal/judge-rules-favor-plaintiffs-challenging-musks-tesla-pay-package-2024-01-30/. Accessed 21st June 2024.

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