Startup Dilution

How funding rounds and liquidation preferences impact deal economics

Ash Sethi / MergerTech

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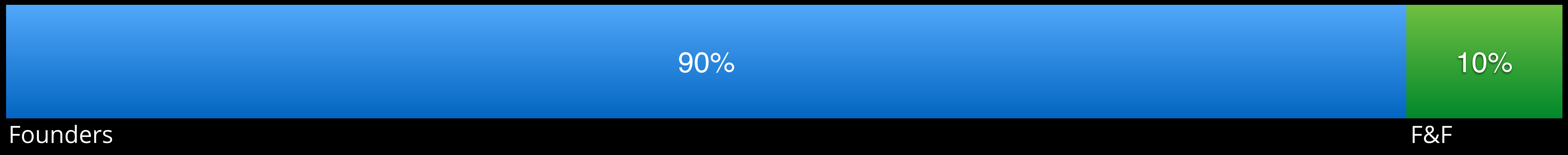
Deal Economics

Seed Round



Lets say you start a software startup. To get going you raise $50,000 in a friends and family round, and offer them 10% of the company.

Valuations on these early stage rounds are often punted until a later funding event as the company generally isn't viable at this point.

Pre-Money	Post-Money
n/a	n/a

Founders' Equity
n/a

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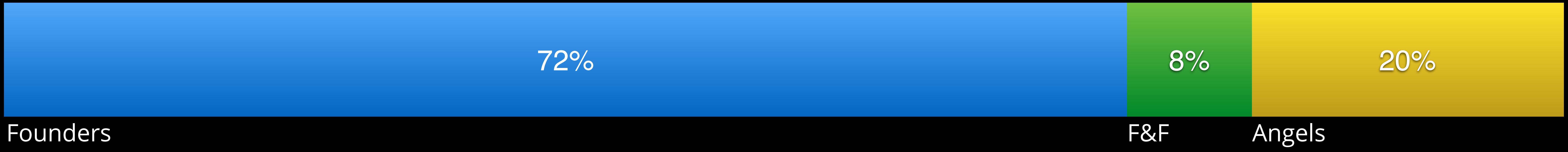
Angel Round



After a few months of toiling in your apartment over endless pizzas and Red Bull, you raise $500K from Angel investors. Angel investments typically come in the form of a convertible note with an interest rate, discount, and valuation cap on the following round. (See Page 9 for more thoughts on convertible notes).

But to simplify the illustration we'll give the Angel common equity at a $2.5M post-money valuation.

Angel investors should really be people who can help you build the product, make customer introductions, facilitate hiring, and grow the business—not just the cheapest or first available money. Chose your Angels wisely!

Pre-Money	Post-Money
$2M	$2.5M

Founders' Equity
$1.8M

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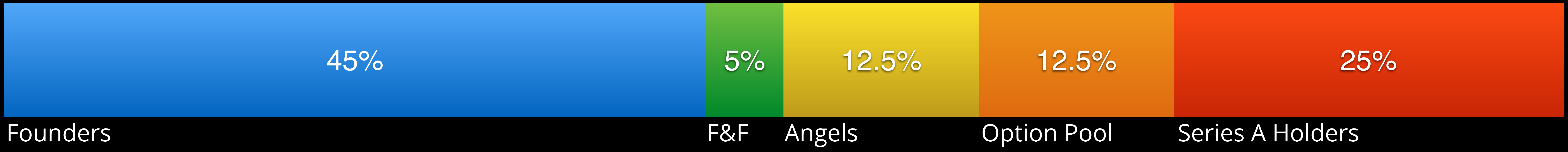
Series A Round



Your startup gets some good press and Venture Capital firms offer you a term sheet: $3M for 25% of the firm (non-participating preferred shares) at $12M post money, with a 1x Liquidation Preference.

As part of the deal, they ask you carve out a 20% option pool for future employees. The thing you don't realize but ought to know is, the dilution on this comes out of the pre-money shareholders. This means the founders, the Angels, and the F&F take the dilution, but the VC fund does not.

Your advisors get hold of the term sheet and hit the roof. While baking in an option pool is standard on VC rounds, the percentage is negotiable. Let’s assume the option pool gets negotiated down to a more reasonable 12.5%.

Pre-Money	Post-Money
$9M	$12M

Founders’ Equity
$5.4M

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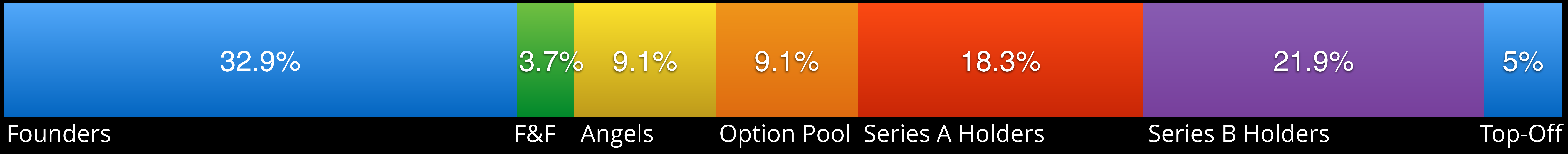
Series B Round



You consider M&A, but your board wants to do another round to achieve an exit closer to $50M.

The company raises a $7M Series B round (consisting of a new VC investor who leads the round, and a re-up by the first VC. They invest only enough to maintain their ownership stake at 25%, and leave the rest of the round to the new investor).

The Series B round is done at a 1x LP, but with uncapped participation. They also insist on an option pool top off so it can incentivize new talent to join the growing startup. Let's call it 5%.

Pre-Money	Post-Money
$25M	$32M

Founders' Equity
$10.5M

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Liquidity Event: $50M All Cash Deal

Lets say a year later you get an LOI for $50M all cash for 100% of the equity. Wahoo!

Now you may think your share of the deal comes to around $16.5M, but your advisors do the math and tell you the founders share is actually closer to $14M.

What the hell!

What ended up happening was $7M in Series B LPs came off the top before any distributions were made. Then the Series B investors got their pro-rata share of the remaining proceeds.

Since the Series A shares were non-participating, they abandoned their LP and converted to common.

So the funds distribution ends up looking like this:

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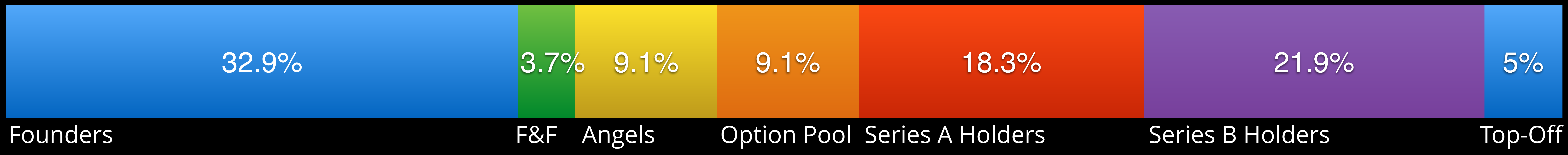
Liquidity Event: $50M All Cash Deal



Holder	LP	Shares	Investment	Return *	ROI
Founders	n/a	Common	n/a	$14.1M	n/a
Friends & Family	n/a	Common	$50K	$1.5M	31.4x
Angels	n/a	Common	$500K	$3.9M	7.8x
Option Pool	n/a	Common	n/a	$6.0M	n/a
Series A Holders	~~1x~~	Preferred (converted)	$3.0M	$7.8M	2.6x
Series B Holders	1x	Participating Preferred	$7.0M	$16.4M	2.3x

*Excludes advisory, legal fees, taxes, debt

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Importance of a Cap to Founders

Holder	Investment	Return Without Series B Cap	Return with 2x Series B cap
Founders	n/a	$14.1M	$15.1M
Friends & Family	$50K	$1.5M	$1.6M
Angels	$500K	$3.9M	$4.2M
Option Pool	n/a	$6.0M	$6.5M
Series A Holders	$3.0M	$7.8M	$8.4M
Series B Holders	$7.0M	$16.4M	$14.0M

We can see that had the Series B shares been capped at 2x participation (meaning their net proceeds from a liquidity event cannot exceed two times their total investment), there would have been more than an additional $2M available for distributions to the common holders.

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The Liquidation Preference

Apart from valuation, the most important thing in an investment term sheet is the liquidation preference (LP) and participation. This has an enormous impact on how the proceeds from a sale (or dissolution) of the company will be distributed. All VC term sheets for preferred stock will contain some flavor of this.

The basis of liquidation preference is that investors get their money back before any other dollars get paid. The concept of participation (sometimes called 'double-dipping') is that the preferred stockholders get to claim their LP, and then be treated as if they converted their shares to common stock and take a pro-rata share in the remaining proceeds.

So let's do the math to see what this really means.

Let's say a VC investor has a participating 2x LP on invested capital of $2.5M, which represents 10% of the fully diluted shares. Your startup sells for $90M. Before anything, they claim their 2x LP at $5M, leaving $85M. They then get pro-rata distribution as if they converted to common for the remaining $85M distribution. This is equal to another $8.5M. So thanks to the liquidation preference and participation, the VC comes out with $13.5M on their $2.5M investment.

If the VC is non-participating, or has a participation cap, it can sometimes make sense for them to abandon their LP altogether and convert to common. This usually happens in higher value deals where there is a larger pro-rata share for everyone.

Talk to an M&A advisor and have them look at your cap table. Depending on your startups capitalization, you may be financially better off selling earlier than waiting for a larger exit several years down the road.

Hi. I'm @techfinanceash

Ash Sethi / Associate / MergerTech

If you're interested in chatting about tech finance
or startups, please get in touch with me at:

www.mergertech.com

asethi@mergertech.com