Improved Venture Capital Preferred Equity Weighted Average Anti-Dilution Terms

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Abstract

Venture capitalistspurchase preferred equity in their portfolio companies, and often attach clauses to that equity which provide specific additional rights for those equity holders. One common such clause providesWeighted Average Anti-Dilution (A-D) protection, creating additional equity when a future round is sold at a lower per-share price. Current practice to calculate the impact of these clauses relies on up to 9 variables, many of which are not directly available at the time of investment or triggering, creating complexity and ambiguity both in reporting holdings in a Capitalization Table during the multi-year life of the investment, and at the critical moment ofsale of the stock (exit), when VC investments convert from Preferred stock to Common stock, and the Anti-Dilution, if triggered, is implemented.

Using the definition of Weighted Average, a more directmethod has been developed, relying on only4 always-available variables: total shares before and after the subject investment, most recent share price, and the dollar amount of new invested capital.

This new approach eliminates a significant source of errors when A-D is triggered and accurately provides: The Conversion Ratio of Preferred Stock to Common, how many new shares are created upon sale of the company and at what price. This alternative approach also directly calculates the Conversion Ratio, rather than the usual Conversion Price, which is merely a preliminary step towards the needed Conversion Ratio:

New (Adjusted) Conversion Ratio: 1: (A+C)/(A+B)

      A   = Fully diluted shares of Common Stock immediately prior to new issue
      B   = Aggregate consideration received by the Corporation with respect to the new issue divided by the purchase price of the prior round
      C   = Number of shares of stock issued in the subject transaction[1]

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[1] Here the "Subject Transaction" is the down round itself