Equity Financing, Dilution and Angel Protections

Owen Davis, Managing Director
Enough About Me

- Run NYC Seed, a Seed fund in NYC with 25+ companies in the portfolio
- Teach at NYU Abu Dhabi and Columbia Law and Business School
- Founder of various startups
Welcome, or Welcome Back.

- Last year we covered:
  - High level overview of what goes in a term sheet
  - Investment structures

- This year, we’re going deeper into specific investor protections:
  - Pro-rata rights
  - Liquidation preferences
Angel Portfolio

- A few key points about being an angel investor:
  - Large enough portfolio
  - Plan financially to follow your winners
Protecting Your Initial Investment

- Angel investors have some levers to protect their initial investment.
  - Common vs. Preferred
  - Upon conversion of convertible note
Protecting Your Initial Investment

• Major investor?
  – Pro-rata/preemptive rights
  – Information rights

• Liquidation and participation
  – By series of stock
Pro-Rata Right

• One of the most important terms in the term sheet for angel investors is pro-rata right:
  – The legal right to participate in later rounds of financing
Pro-Rata Definition

• There is more than one definition of pro-rata
  − Maintain your current % ownership through future rounds
  − % of the future round
Our Discussion Scenario

• You invest $100k in the seed round in a company that raised $14M and is sold for $55M

<table>
<thead>
<tr>
<th></th>
<th>Total Round</th>
<th>Post-Money Valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Series Seed</td>
<td>$1M</td>
<td>$6M</td>
</tr>
<tr>
<td>Series A</td>
<td>$4M</td>
<td>$16M</td>
</tr>
<tr>
<td>Series B</td>
<td>$9M</td>
<td>$51M</td>
</tr>
</tbody>
</table>
### Pro-Rata Effect on Ownership - $100K Invested

**Exercise pro-rata**

<table>
<thead>
<tr>
<th>Your stake</th>
<th>Shares (scaled/100)</th>
<th>Get diluted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seed</td>
<td>1.18% 100</td>
<td>1.18% 100</td>
</tr>
<tr>
<td>Series A</td>
<td>1.43% 150</td>
<td>0.95% 100</td>
</tr>
<tr>
<td>Series B</td>
<td>1.47% 187.5</td>
<td>0.78% 100</td>
</tr>
</tbody>
</table>

*Get diluted*
Initial vs. Follow-on Investment

- Follow on investments could equal many times the initial investment
  - In our scenario initial $100k investment and $250k pro-rata over 2 future rounds
Pro-Rata Value Creation

- It would have cost you an additional $250k to maintain your pro-rata through all rounds.
  - In our scenario initial $100k investment and $250k pro-rata over 2 future rounds

<table>
<thead>
<tr>
<th>Pro-rata Amt:</th>
<th>Becomes...</th>
<th>Total Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000</td>
<td>$431,200</td>
<td>$431,200</td>
</tr>
<tr>
<td>$100,000</td>
<td>$215,600</td>
<td>$646,800</td>
</tr>
<tr>
<td>$150,000</td>
<td>$161,700</td>
<td>$808,500</td>
</tr>
<tr>
<td>$350,000</td>
<td>$161,700</td>
<td>$808,500</td>
</tr>
</tbody>
</table>
Multiple Created Full Pro-rata

Obviously, Early Rounds Shares Have Better Returns

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$431,200</td>
<td>$100,000</td>
<td>4.3x</td>
</tr>
<tr>
<td>$646,800</td>
<td>$200,000</td>
<td>3.2x</td>
</tr>
<tr>
<td>$808,500</td>
<td>$350,000</td>
<td>2.3x</td>
</tr>
</tbody>
</table>
Pay to Play

• In some “down round” financings, if investors don’t participate or take their pro-rata amount in the financing they lose certain rights.

Many variants. Could include:

− Loss of anti-dilution protection
− Forced conversion to common shares (and loss of preferred rights)
What does Selling a Company and Your % Ownership Mean?

It depends!
He Who Has the Gold…The Preference Stack

• The later (and larger) investors get seniority for their money upon exit.
  − Downside protection for lower exits
  − Angels at the bottom of the stack (common or earliest preferred)
The Preference Stack

- **Series B**: More senior, first payout
- **Series A**: Less senior, last payout
- **Seed**
- **Common, Options**

More senior, first payout

Less senior, last payout
Non-Participating Preferred

Get the greater of: either your pro-rata percentage of proceeds or your original purchase price
Get your original purchase price and after all preferred investors have been paid, share ratably in the remaining proceeds.
Participation with Cap on Exit

Receive original purchase price for all preferred shareholder then share ratably until a multiple of the original purchase price is met
Why Preferred Shares Matter?

• In the event of moderate exits, senior investors get paid first.
  
  – Owning multiple classes of stock at different seniority levels help mitigate some risk
Modest Exits and Proceeds

• In our scenario, instead of a $55M exit:

<table>
<thead>
<tr>
<th>Exit in $M</th>
<th>Angel Common</th>
<th>Seed Preferred</th>
</tr>
</thead>
<tbody>
<tr>
<td>$15M</td>
<td>$24,750</td>
<td>$350,000</td>
</tr>
<tr>
<td>$20M</td>
<td>$150,000</td>
<td>$350,000</td>
</tr>
</tbody>
</table>
**Result of Preference on Proceeds**

- In our scenario, instead of a $55M exit:

<table>
<thead>
<tr>
<th>Exit in $M</th>
<th>All Common Own</th>
<th>% of Proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>$15M</td>
<td>40%</td>
<td>4%</td>
</tr>
<tr>
<td>$20M</td>
<td>40%</td>
<td>20%</td>
</tr>
</tbody>
</table>
Type of Participation and Proceeds

- In our scenario, at a $55M exit, an investor may receive more than just their % ownership of the company:

<table>
<thead>
<tr>
<th>Type of Participation</th>
<th>Proceeds</th>
<th>Ownership %</th>
</tr>
</thead>
<tbody>
<tr>
<td>No Participation</td>
<td>$808,500</td>
<td>1.47%</td>
</tr>
<tr>
<td>Participating Preferred</td>
<td>$952,700</td>
<td>1.73%</td>
</tr>
</tbody>
</table>
Keep in Mind

• **Pro-rata**
  - Ability to fund winners
  - Combined multiple of later rounds
  - Major investor

• **Preferred Shares**
  - Preference and stack
Thank You

Owen Davis
owen@nycseed.com