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Anti-dilution protection

The context for anti-dilution protection

Venture capital investment is critical for the development of emerging start up and growth companies and helps such companies realise their potential.

Venture capital investors, meanwhile, benefit from the growth of the companies in which they invest. The more potential growth a venture capital business realises, the greater the potential reward for the investors is but this is always set against a high risk profile for investors, given the nature of the businesses they are backing.

Start-up and other early stage businesses have obvious hurdles to overcome (be they financial or otherwise) on their growth journeys and consequently, venture capital investors are concerned with finding a balance between investing in exciting early stage fast growth businesses but also protecting the value of their investment and ensuring they haven't overpaid for something. Anti-dilution is one such protection which may be required by investors.

What are anti-dilution rights?

When investors agree to make an investment in a company they will do so based upon an agreed pre-money (or post-money) valuation. This valuation then generates the price per share that is paid on an investment round.

The typical business model for venture capital backed businesses requires them to seek further funding as they achieve certain milestones and need further cash to progress to the next phase of growth.

In an ideal world when the company comes to raise such future investment round it will do so at a higher valuation than its previous round.

However, this is not always possible and "down rounds" whereby a lower valuation is attached to the company than was previously paid are not uncommon.

Anti-dilution rights seek to compensate investors that invested at the higher valuation, by issuing them additional shares at no cost for effectively overpaying on the previous round. Fundamentally, anti-dilution protection is designed to ensure the interests of investors are not unduly compromised (and the value of their investment thereby undermined) if the company's share price should fall.

Such provisions will typically be contained in the company's articles of association.

What are the types of anti-dilution rights?

The number of additional shares that existing investors might receive on a down round will depend on the type of anti-dilution right that was included on the previous investment.

There are two standard types of anti-dilution protection commonly seen:

1. **Full ratchet protection** – this is the most favourable for investors and issues such number of additional shares to the existing investors to put them in the position as if they had invested on the last round at the lowest price per share paid on the next round, regardless of the number of shares issued. For example, if an investor bought shares at £10 per share in the first round, and the company issues shares at £5 per share in the second round, the investor would receive such number of additional shares to double their shareholding. This is particularly punitive for founders / non-investor shareholders as it is very dilutive and is much less common than a weighted average mechanism.
2. **Weighted average** – this is the most common form of anti-dilution protection that is included in UK venture capital transactions. In the event of a down round the number of additional shares to be issued is adjusted to account for the lower share price paid on the latest round but the formula used also takes into account the total number of shares in the fully diluted share capital of the company prior to the down round, the total investment received by the company during the round and the number of new shares issued as part of the down round. The resulting number of additional shares to be issued after the down round is therefore based on a weighted average with the result that the number of additional shares is linked to the amount of capital raised and the number of shares issued as part of the down round, rather than simply the price paid for one share. For example, if an investor buys shares at £10 per share in the first round, and the company issues shares at £5 per share in the second round, the investor will receive additional shares to compensate them for a weighted average price that is lower than £10 but higher than £5, depending on the size of the second round (i.e. the more shares issued on the second round at the lower valuation, the more additional shares that will be issued under the anti-dilution rights). This is much more widely used and more balanced (between the interests of the company and the investor) than a full ratchet mechanism. There are then two types of weighted average rights:
    a. Broad based weighted average – this is the most common form and the default starting point in the BVCA documents and is as described above. This the most likely form of anti-dilution right that a company will be asked to include in its investment documents.
    b. Narrow based weighted average. This by and large follows the above description save that where the broad-based weighted average formula refers to the fully diluted share capital of the company (i.e. including options), the narrow-based formula only considers shares actually in issue at the relevant time.

Are there are any alternative mechanics for how does anti-dilution protection can work?

Anti-dilution protection does not necessarily require the company to issue any additional shares as is commonly thought. For example in the US the typical mechanism simply adjusts the number of ordinary shares which each preference share (or other convertible stock) will ultimately convert into on exit to compensate investors that way.

Recommendations

It is essential that protections such as anti-dilution provisions are right for companies / founders and both new and existing investors alike. It is essential that the implications are fully understood on both at the point at which an investor makes their investment and again, as and when the company raises further investment.

Therefore, founders and investors should carefully consider the implications of different types of anti-dilution rights before agreeing to them and try and avoid agreeing to the inclusion of anti-dilution rights on a full ratchet basis. Ideally the impact should be modelled in a caps table so all parties are clear on the ramifications of accepting anti-dilution rights.

We have substantial experience acting for a wide range of clients, on both company and investor side in all aspects of venture capital investment and so are well placed to support you with decisions of this type and with any other aspects of the lifecycle of a venture capital business, so please do get in touch with any queries.

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