

Equity Matters

5. The Deal – Part 3

Exit and Downside Management

28-06-2022



Today's Speakers



Tom Early

Head of Equity & Legal
Enterprise Ireland



Killian McMahon

Senior Investment Advisor
Enterprise Ireland



Brendan Noud

CEO and co-founder
LearnUpon

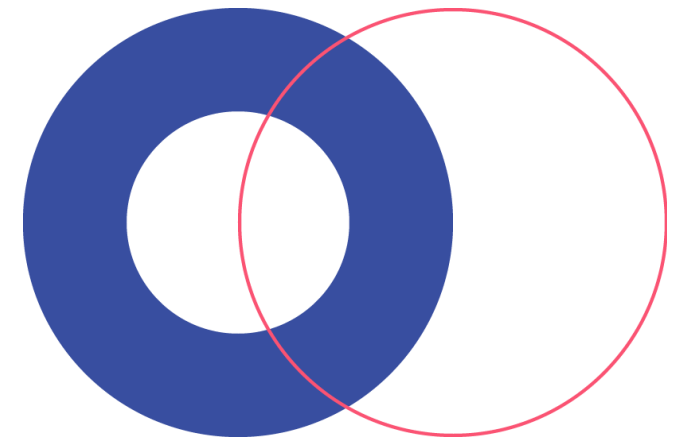
Exit & Downside Management





Exit & Down-Side Management

- + Preferred Shares:
 - *New shares ranking ahead of ordinary / existing shares and often have additional rights to ordinary shares*
- + Pre-emption / pro rata:
 - *Existing investors can invest in subsequent rounds to maintain their percentage shareholding*
 - *This is an extremely important right*
 - *The disapplication of pre-emption rights can often be approved by Investor Majority*





Exit & Down-Side Management

- + Participating liquidation preference:
 - *Investors receive their preference first and are then entitled to a share of any remaining funds based on their ownership percentage (sometimes known as double-dipping)*
- + Non-Participating liquidation preference:
 - *Investors receive the greater of the preference amount with no further right to distributions or their proportionate share of distributions but without the preference*
- + 1x Liquidation Preference:
 - *Investor receives one times its investment before lower ranking shareholders*

A large red 'C' shape is positioned in the top right corner. A blue geometric shape, resembling a stylized 'L' or a corner, is located in the bottom right corner. A small blue square is in the top left corner.

Exit & Down-Side Management

- + Redemption right:
 - *The repurchase options for an investment*
- + Conversion option:
 - *Investor can convert an investment into voting shares*
 - *What is the conversion price?*
 - *What amount is convertible e.g. is the principal and accrued dividends converted?*
 - *Is the conversion option anytime, automatic or exercisable on a future event?*
 - *Does the investment convert into a fixed shareholding percentage e.g. SAFEs can convert into a prescribed post-money shareholding percentage?*



Exit & Down-Side Management




Anti-dilution:

- *Protection of investor percentage shareholding from dilution on subsequent share issues*
- *Price-based: When a company raises money in a down round, the new investment is viewed as diluting the share value of the earlier investors and earlier investors receive bonus shares*
- *Contractual: This provides for a non-dilutive shareholding regardless of the new share price*
- *For example, if you had a 5% shareholding, you would maintain this shareholding post new investment rounds*

Full ratchet anti-dilution rights:

- *In a down round, the investor will receive additional shares as if the investor paid the round's lower price*

Weighted average anti-dilution rights:

- *In a down round, the investor will receive shares, but unlike a full ratchet provision, the adjustment size depends on the number of shares sold relative to the company's existing shares as well as the difference in the share price*
 - *Can be narrow-based weighted average or broad-based weighted average*
- 



Exit & Down-Side Management

- + Drag right:
 - *The right of certain shareholders to force other shareholders to join them in the sale of the company*
- + Tag Right:
 - *An agreement by shareholders that they will not sell any of their shares in the company without giving the other shareholders the right to participate in the sale, usually pro-rata to their shareholdings*
- + Right to appoint a seller:
 - *An investor can appoint a professional firm to try and sell its shares / the company*



Exit & Down-Side Management

- + Registration Rights:
 - *Right to demand that company management exercise best effort to complete an IPO*
 - *Usually seen in investment agreements with US VCs*
- + IP assignment:
 - *The company's Intellectual Property is assigned to the investor until certain milestones are met*
- + Founder share vesting:
 - *The founder's shares vest over an agreed period to ensure the founder is incentivised to remain with the company*
 - *Example: 25% of a founder's shares vest immediately with the remaining 75% of shares vesting monthly for the next 3 years*



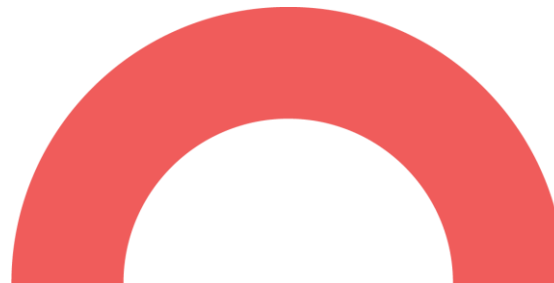
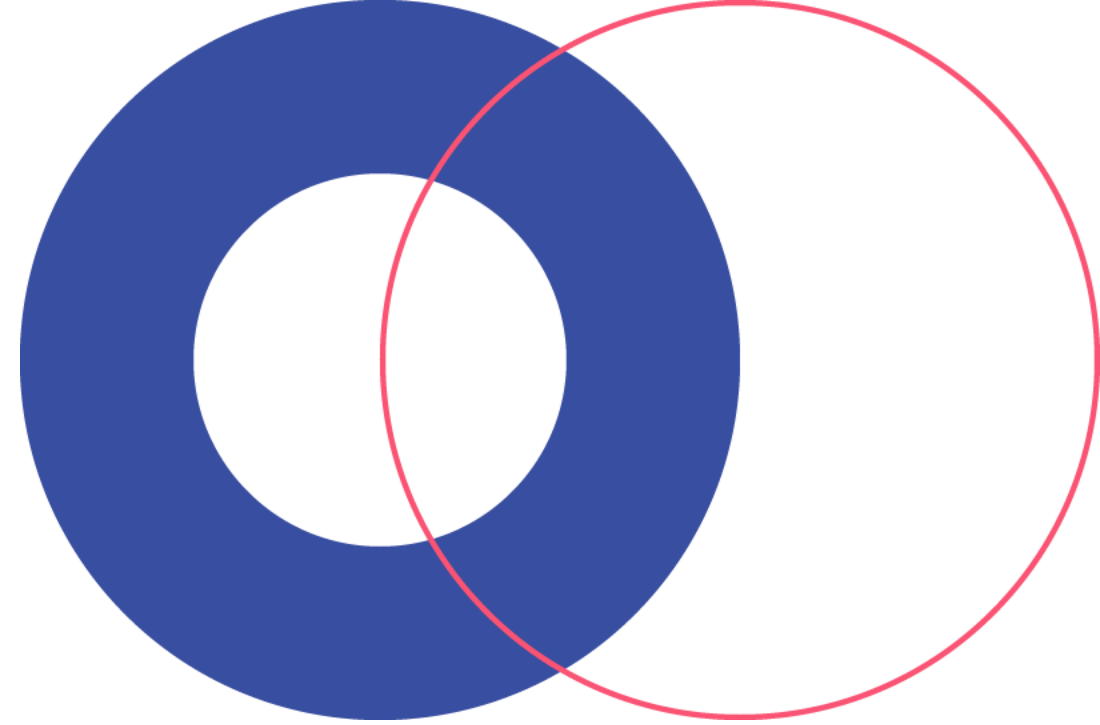
Exit Options

- + VCs secure control over exits through:
 - *Drag along clauses*
 - *Defined periods for returns*
 - *Board veto rights*
- + VCs secure exit benefits through:
 - *Conversion rights*
 - *Liquidation preferences*
 - *Ratchets and guaranteed returns*



Preferred Shares

- + Anti-dilution rights
- + Liquidation and conversion rights
- + Decision making rights
- + Restrictive covenants
- + Follow-on investment rights
 - *Pre-emption*
 - *Tag along*
 - *Drag along*





Appendix A Useful Resources

- + blog.ycombinator.com/a-standard-and-clean-series-a-term-sheet/
- + [US statistics on investment terms](#)
- + [SAFE explanation](#)
- + nvca.org/resources/model-legal-documents/

Appendix B — Anti-Dilution Example

Original Cap Table	A	B		C	D	E		
Share type	Shares Outstanding	Issue Price	Invested Capital	Liquidation Preference per Share	Conversion Price	Conversion Ratio	Fully Converted Shares	Fully Converted Ownership %
Series A Preferred Shares	2,000,000	€10	€20,000,000	€10	€10	1.00	2,000,000	19.23%
Ordinary Shares	8,400,000						8,400,000	80.77%
Totals							10,400,000	100.00%

New Round				
-----------	--	--	--	--

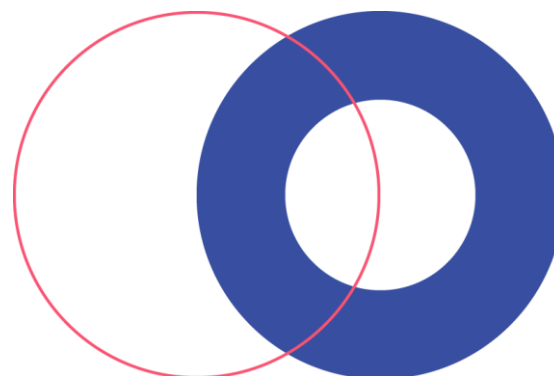
5,000,000 Series B convertible preferred shares at €8 per share.

Original Cap Table								
Share type	Shares Outstanding	Issue Price	Invested Capital	Liquidation Preference per Share	Conversion Price	Conversion Ratio	Fully Converted Shares	Fully Converted Ownership %
Series A Preferred Shares	2,000,000	€10	€20,000,000	€10	€10	1.00	2,000,000	12.99%
Series B Preferred Shares	5,000,000	€8	€40,000,000	€8	€8	1.00	5,000,000	32.47%
Ordinary Shares	8,400,000						8,400,000	54.55%
Totals							15,400,000	100.00%

Appendix B - Anti-Dilution Example

New Capital Structure — FULL RATCHET Anti-Dilution Protection

Share type	Shares Outstanding	Issue Price	Invested Capital	Liquidation Preference per Share	Conversion Price	Conversion Ratio	Fully Converted Shares	Fully Converted Ownership %
Series A Preferred Shares	2,000,000	€10	€20,000,000	€10	€8	1.25	2,500,000	15.72%
Series B Preferred Shares	8,400,000						5,000,000	31.45%
Ordinary Shares							8,400,000	52.83%
Totals							15,900,000	100.00%



Appendix B - Anti-Dilution Example

New Capital Structure — NARROW-BASED WEIGHTED AVERAGE Anti-Dilution Protection

Share type	Shares Outstanding	Issue Price	Invested Capital	Liquidation Preference per Share	Conversion Price	Conversion Ratio	Fully Converted Shares	Fully Converted Ownership %
Series A Preferred Shares	2,000,000	€10	€20,000,000	€10	€8.57	1.17	2,333,333	14.83%
Series B Preferred Shares	5,000,000	€8	€40,000,000	€8	€8	1.00	5,000,000	31.78%
Ordinary Shares	8,400,000						8,400,000	53.39%
Totals							15,733,333	100.00%

Conversion Price = Original Series A Share Price * (A + B) / (A + C)

A = Preferred Shares prior to new round (i.e. 2,000,000)

B = New investment amount divided by Series A price per share

C = New Series B preferred shares

Conversion Price = €10 * (2,000,000 + 40,000,000 / €10) / (2,000,000 + 5,000,000) = €8.57

Appendix B - Anti-Dilution Example

New Capital Structure — BROAD-BASED WEIGHTED AVERAGE Anti-Dilution Protection

Share type	Shares Outstanding	Issue Price	Invested Capital	Liquidation Preference per Share	Conversion Price	Conversion Ratio	Fully Converted Shares	Fully Converted Ownership %
Series A Preferred Shares	2,000,000	€10	€20,000,000	€10	€9.35	1.07	2,138,889	13.76%
Series B Preferred Shares	5,000,000	€8	€40,000,000	€8	€8	1.00	5,000,000	32.18%
Ordinary Shares	8,400,000						8,400,000	54.06%
Totals							15,538,889	100.00%

Conversion Price = Original Series A Share Price * (A + B) / (A + C)

A = Total Shares prior to new round (i.e. 10,400,000)

B = New investment amount divided by Series A price per share

C = New Series B preferred shares

Conversion Price = €10 * (10,400,000 + 40,000,000 / €10) / (10,400,000 + 5,000,000) = €9.35

- + Broad-based weighted average is the most common form of anti-dilution right
- + Offers the greatest flexibility in the negotiation of new financing rounds for company management

Questions & Answers

Thank You

- + The next webinar is EXITS on Tuesday 26 July @3pm
- + Here's the link to the series:
globalambition.ie/equity-matters-webinar-series/
- + For more information on the supports mentioned:
visit enterprise-ireland.com.