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DEEP DIVE INTO DOWN-ROUND MECHANICS

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What is a Down-Round

A down-round is a fundraising round of a company in which the pre-money valuation is lower than the post-money valuation of the company in the preceding fundraising round. In a down-round, shares are issued at a lower price than in the preceding round, thereby creating a dilutive impact on the net value of prior round investments.

A down-round is anathema to all stakeholders because it is damaging to market perception of the company, the founders, and the existing investors backing them. Down-round investors also typically require changes to a company's status quo, some of which might entail making tough and unpopular (but necessary) decisions. Because of the significant deterrents to a down-round, they are often used as a last resort means to keep the company afloat. We will now examine some terms that are relevant in a down-round.

Anti-dilution Rights

Anti-dilution rights are one of the tried and tested methods for protecting an existing shareholder's investments in the event of a down-round.

The anti-dilution clause mitigates the dilutive impact of a down-round by either (i) lowering the price or increasing the ratio at which the existing preference shares and convertible instruments will convert to ordinary shares (the goal being to give the holder more ordinary shares upon conversion or deemed conversion); or (ii) issuing more shares to the existing investors. The latter method is generally avoided as it requires an iterative exercise of balancing (i) the number of shares to be issued to each investor; (ii) the number of new shares to be issued to the incoming investor; and (iii) the dilutive impact on the net price per share of each new share being issued.

Without going into the details, there are three common variations of the anti-dilution clause, (i) the broad-based weighted average variation; (ii) the narrow-based weighted average variation; and (iii) the full-ratchet variation. All three adjust the conversion price or ratio that existing shares and convertible instruments convert to ordinary shares.

The broad-based variation results in the smallest anti-dilutive adjustment for the protected shareholders while

the full-ratchet variation gives the largest adjustment but also results in the largest dilution to the ordinary shareholders, and hence is typically resisted by founders and existing investors.

In a down-round, it is common for incoming investors to request a full-ratchet anti-dilution protection. In severe down-rounds, the incoming investors might additionally request for such protection to be in the form of dilution shares being issued upfront to them in a subsequent down-round (rather than the typical adjustment to the conversion price or ratio), because the dilution shares will increase their net shareholding percentage immediately, allowing them to have greater effective control and influence over the company and decision-making processes after subsequent down-rounds. Down-round investors might also bundle in additional provisions in the existing down-round, such as pay-to-play clauses which force conversion for existing preference shareholders into ordinary shareholders, at which point the existing preference shareholder lose their preferential economic rights, class veto rights and anti-dilution protection if they do not co-invest alongside the incoming investors. These measures are typically justified by the need for the incoming investor to determine the direction of the company moving forwards, and to defend its investment should a subsequent down-round be needed.

Liquidation Event and Liquidation Preference

A liquidation event is an event that results in a distribution of proceeds by the fundraising company to all shareholders according to their liquidation preference rights. A liquidation preference right grants the holder a right to funds or proceeds arising from a liquidation event in preference to other shareholders.

Readers would be familiar with the common liquidation events generally revolving around (i) significant capital return or restructuring events of the company, such as winding-up of subsidiaries or mergers and consolidations; (ii) significant sale or disposal events at the company level such as a sale of the business or substantially all of the assets.

The liquidation preference right is varied typically in terms of (i) ranking; (ii) quantum; and (iii) type. Ranking determines the order that each shareholder class is entitled to receive the proceeds of a liquidation event. The quantum of the liquidation preference is

the amount that each shareholder takes during its turn in the waterfall, usually expressed as a multiple of the capital invested by that shareholder (i.e. 1X, 2X etc.). Finally, a liquidation preference right can either be of a “participating” or “non-participating” type, the difference being that participation entitles a shareholder who has already received its preferential proceeds, to again share with the other ordinary shareholders in the leftover liquidation proceeds. The non-participating variety limits the shareholder to its preferential proceeds, and it will not be entitled to any other distribution from any leftover liquidation proceeds.

In a down-round, an incoming investor will want a combination of a widely-defined list of liquidation events and a liquidation preference superior to the extant rights in order to maximise instances where liquidation proceeds will be distributed and ensure as much of those proceeds are distributed to itself in priority to everyone else, before taking out of those proceeds yet again with everyone else (i.e. a participating right).

A recent construct that is gaining traction among down-round investors is a modification to the sale of company shares by shareholders. In a typical sale of shares, proceeds usually reside with the seller. In this construct however, the incoming investor negotiates in conjunction with its exit rights for proceeds from any sale of shares to be distributed to all the shareholders in accordance with the liquidation proceeds distribution waterfall. Approaching a clause such as this is particularly tricky as there are conflicting stakeholder interests at play which have to be weighed including (i) ensuring potential selling shareholders are not unduly penalized by selling their shares but receiving little or no proceeds because of their inferior liquidation preference rights and balancing this against the non-selling shareholders unduly benefitting by keeping their existing shares but yet being entitled to a substantial portion or even all of the proceeds because of their superior liquidation preference rights; and (ii) creating wrong incentives for management thereby discouraging potential exits and buy-outs. Readers should take note however that potential sellers do have instruments at their disposal in order to either restrict the applicability of such clauses or to ameliorate their effect. One such instrument is a drag-along right, which gives a potential seller the right to compel all other shareholders to sell alongside with it, thus triggering a liquidation event where proceeds are distributed more “equitably” to all shareholders through the liquidation waterfall.

We have been seeing down-round investors asking for enhanced participating liquidation preferences at higher multiples. The general rule of thumb is the larger the upfront liquidation preference multiple, the weaker the justification for participation rights. In some instances, founders and management (usually holding ordinary shares) were given participating liquidation preferences (in the form of enhanced founder and management preference shares) as part of the terms of the down-round in order to incentivise and enfranchise them.

Alternative liquidation preference waterfalls can also be used to create incentives around increasing valuation and meeting performance indicators. For example, a 3X participating liquidation preference that falls away (or reverts to a “friendlier” liquidation preference similar to other prior round shareholders) upon the close of a subsequent fundraising round at a higher valuation, or a liquidation preference that varies according to the implied valuation of the company in any liquidation event.

Redemption Rights

A redemption right enables the holder to compel the company to redeem its shares at capital investment plus interest, after an agreed timeframe. The redemption right for a down-round investor may be viewed as a “consolation” exit scenario, included as an indicative expectation of maximum exit timeframe, minimum exit returns, rather than as the primary means of investment returns.

Down-round investors may require the redemption timeframe of all other redeemable preference shares be marked to the redemption timeframe in the down-round shares, so that no other class of shares may be redeemed earlier than the down-round shares.

An issue that we have encountered increasingly of late is that in order for the company to continue carrying on as a going concern, provisions are required to be made in the audited accounts for full redemption, regardless of the redemption horizon or terms. This is challenging for fundraising companies that are seldom if at all, profitable until later stages. Also, future incoming investors typically insist on audited accounts as a requirement of their investment committees and financial due diligence and such concerns if flagged in reports will be detrimental to investment committee approval.

The redemption timeframe “refresh” is usually strongly resisted by existing investors, especially in the case of investment funds that have their own deployment and exit timeframes. In such cases, the incoming investor who takes a view that an up-round is, while not imminent, at least foreseeable, will take this opportunity to swing the discussions towards either a direct purchase (usually at the initial capital investment price plus redemption interest) or a forced redemption of these shares using the proceeds of the down-round at a discount.

Conclusion

This article serves only as a summary of headline issues often encountered in a down-round scenario. These issues are however only the tip of the iceberg and the down-round journey will require deft navigation.