Avoiding Hidden Dilution in Growth Equity and Venture Capital Investing

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Venture capital and growth equity investors who have negotiated a favorable pre-money valuation with an attractive target company may still make a costly mistake if they fail to focus on how option pool expansions, as well as convertible note and SAFE conversions, impact their pro-forma ownership.

As explained in our Simple Cap Table Analysis article, you can quickly and easily determine what your ownership percentage of the company should be following your investment by using simple math: assuming you invest X in a company valued at Y, you should receive a percentage of the fully diluted equity of the company equal to X / (Y+X)[1]. However, in many instances, the ownership percentage you receive through this formula is higher than the ownership percentage reflected in the company's pro forma cap table. The reason for the variance is almost always an artifact of dilution resulting from other aspects of the transaction (i.e., option pool expansions and convertible note or SAFE conversions).

As discussed in the article Two Sides of the Same Coin: the Direct Relationship of Valuation and Dilution in Pricing Venture and Growth Equity Deals, if you agree to bear a part of the dilution for option pool expansions or similar adjustments, you are effectively agreeing to a higher pre-money valuation. For example, if an option pool (Z) is borne by all owners on a post-money basis, you would end up with a post-investment ownership percentage equal to X / (Y+X+Z) (where Z equals the number of options multiplied by the exercise price per share), and so an option pool equal to 10% of the post-money valuation would effectively dilute your ownership by 10%. A similar effect is observed when the dilution resulting from the conversion of convertible notes and/or SAFEs is borne on a post-money basis. See: "Who Bears It," Part 1: The Option Pool Shuffle; and "Who Bears It," Part 2: Economic Arguments for Convertible Note / SAFE Dilution.

To avoid effectively conceding a hard-won valuation, you should be sure to clearly specify that the basis of the calculation of the fully diluted pre-money valuation will include the effect of the option pool expansion and the conversion of any convertible notes and/or SAFEs. To accomplish this outcome, the term sheet should include language similar to the following: "[the investment will be made] at a pre-money valuation of the Company of $[ ] million, calculated on a fully diluted basis (inclusive of an unallocated and uncommitted option pool of [ ]% of the fully-diluted post-money equity capitalization as of immediately following the Closing, and the conversion of any outstanding convertible notes and/or SAFEs)."

[1] Note that this assumes that X represents the entire investment – i.e., there are no other investors also investing.

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The reference to "post-money equity capitalization" accounts for the dilution to the option pool as a result of the option pool itself (i.e., the shares allocated to the option pool increase the total capitalization of the company, and so to achieve the fixed percentage of option pool equity, it needs to be referenced as the post-money equity). The reference to the conversion of any outstanding convertible notes and/or SAFEs is to make clear that any additional equity issuances that may occur as a result of the new priced round (e.g., because of the conversion of convertible notes) would be borne solely by the existing investors and not the new investor.

Therefore, through careful construction of the term sheet, the lead investors can ensure that they will not inadvertently surrender ground from a favorable valuation negotiation.

If you have any questions, please contact your primary attorney at Seward & Kissel LLP or Gary Anderson at anderson@sewkis.com or Eric Buchanan at buchanan@sewkis.com.

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