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What every CEO needs to know about 'down rounds'

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Down rounds have typically been seen in a negative light, but a recent Axios Pro Rata article[1] raises an interesting point. If everyone raises a down round, does anyone really notice? Do they still have the same negative implications if they are happening across the board? With current conditions making down rounds more of a necessity for many startups, it's time to take a closer look at the down round and the alternatives.

What is a down round?

Private companies raise money through a series of investments called rounds. In a perfect world, each round is expected to have higher pricing as the valuation of the company goes up.

For some companies, a down round may be the only way to survive.

Not everything goes as planned, however, and companies will often pivot, and investors give them a second chance, at an albeit lower price.

There are several factors that can impact a company's valuation, including hiring, growth, revenue, emergence of a competitor in the market and obsolescence, not to mention the overall funding environment. When new investors examine these and other factors, they might determine the valuation of the company is not as high as the previous round.

When that valuation drops below the level of previous rounds, and the company still needs further investment to move forward, they might look to a down round. In a down round, the company will sell shares of stock to new investors at a price that is lower than its previous round(s).

What are the implications of a down round?

As stated before, down rounds can have a negative perception. They can lead to greater dilution, loss of confidence in the company, as well as lower employee morale.

But for some companies, a down round may be the only way to survive, and with current conditions, the need for funding might outweigh these negative factors.

In any investment round, the founders and previous investors are going to see dilution and a reduction in their ownership percentage. As new investors come on board, their piece of the pie is reduced. The difference is that in an up round, that dilution is combatted a bit by the higher stock price of the new shares. In a down round, that does not happen and the impact of the dilution for founders and previous investors is greater.

A down round can also trigger anti-dilution protections for investors. These protections are built in for investors as they have a different category of stock than the founders and company employees. If anti-dilution protections are triggered in a down round, their stock would be diluted less than that of the founders or employees.

There are two different anti-dilution protections that can be used in a down round.

Weighted Average Adjustment: This is the more commonly used protection. In this case, the adjustment is based on the size and price of the down round in comparison to the previous round.

Startup CEOs and investors can seek to avoid down-rounds by offering other investor-friendly terms beyond baseline price.

Full Ratchet Adjustment: This option provides greater protection for existing investors as it essentially adjusts the price of investors' prior rounds to the lower pricing. This means that the founders and employees' stock would take the brunt of the dilution resulting from the down round.

No matter which anti-dilution protection is used, there will be accounting implications as these come with reporting requirements. This can also cause a dip in employee morale as they see their ownership impacted disproportionately to investors.

Let's not forget the impact of a down-round to the existing investors. Often times, new investors will make their new investment conditional upon the existing investors waiving their anti-dilution protections. Particularly for newsworthy down-rounds, there is negative reputational impact.

One need not look any further than the hit taken by SoftBank's Vision Fund, who invested in Swedish "buy now pay later" giant Klarna in June 2021 at a $45.6 billion valuation, only to see its investment slashed into one seventh of what it was valued upon a July 2022 down round resulting in a $6.5 billion valuation.

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Following this announcement, SoftBank CEO Masayoshi Son has publicly expressed a change in strategy, preferring smaller ticket sizes, lower equity holding and more numbers.

Are there alternatives to a down round?

There are of course alternatives to a down round, but they don't always make sense or work in every situation. The obvious solution is for companies to spend less and operate more efficiently, but if that was not the problem that has led to the need for additional funding, this is not an option.

Startups can also look to bring in money through different avenues such as short-term, bridge financing, accelerated multi-year revenue deals with upfront cash payments, government incentives or shared revenue agreements. There is also the option to renegotiate with their original investors, and depending on the circumstances, the company might look to close entirely.

Startup CEOs and investors can seek to avoid down-rounds by offering other investor-friendly terms beyond baseline price.

For example, they can offer liquidation preferences at a price greater than what was paid, accruing dividends, participating preferred dividends, warrant coverage or issuance of additional shares of another security.

Startup CEOs can attempt to negate the impact of these incentives on the current management team by packaging them with a new management carve-out plan that guarantees a minimum percentage or dollar amount from the liquidation stack for management.

Importantly, vesting terms could be negotiated then and there, or left to be determined later. Strap on your seatbelt, these are dizzyingly complex negotiations, and consider reserving a piece for a "rights" offer to existing holders of the common.

"Pay to play" or "pull up" financing mechanisms can attempt to force existing investors to put in more money for fear of getting converted into common stock at an embarrassing conversion price. These mechanisms require a new lead investor to put in a chunk, and some cooperation with existing investors who are willing to participate. Put your helmet on, these are very tough discussions.

The valuation of public companies has a direct impact on startup valuations and their ability to raise money. With the markets in turmoil right now, founders need to be making the most prudent decisions for their company and looking at every way to save where they can. But even those startups operating at the highest level of efficiency can find themselves needing to raise additional capital, and in today's conditions, that could easily be at a lower valuation than they expected.

As we asked from the beginning, if startups begin raising down rounds at a greater rate, will they face the same negative impact we have seen in the past? That remains to be seen.

But for the time being, conditions don't seem to be changing. This means it is critical for founders to fully understand the potential implications of a down round and how to best navigate through the process to bring in the funding they need, while lessening the negative aspects that can come with the down round.

Notes

[1] https://bit.ly/3zp2Cj0

About the author

Louis Lehot is a partner at **Foley & Lardner LLP** based in the firm's San Francisco, Silicon Valley and Los Angeles offices who specializes in emerging growth companies, venture capital, and mergers and acquisitions. He provides entrepreneurs, innovative companies and investors with legal strategies and solutions at all stages of growth. He can be reached at llehot@foley.com. This article was originally published July 20, 2022, on the firm's website. Republished with permission.

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