ANTI-DILUTION PROTECTIONS - ARAOZ & RUEDA

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Private equity (PE) investors generally seek protection from dilution by other investors in later rounds. Anti-dilution protection is separate from the preferential subscription rights, which give priority to existing shareholders to subscribe for new shares in proportion to their interest in the company. Anti-dilution provisions retroactively reduce the price per share paid by the PE investors in the event that the company's later rounds of capital increases reflect a lower enterprise value than that taken into consideration at the time of their initial investment.

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Even when a depreciation in company value cannot be attributed to company underperformance (ie changes to applicable multiples as a consequence of adverse financial conditions), investors can protect their percentage interest and, therefore, their portfolio value by implementing antidilution protection.

Los inversores de capital riesgo buscan normalmente la protección contra la dilución de otros inversores que se incorporarán posteriormente al accionariado de la empresa. Esta protección contra la dilución es independiente de los derechos preferentes de suscripción por los que el accionista podrá dedicarse a nuevas acciones en función de sus intereses en la empresa. En este artículo, Francisco Aldavero, jefe del área de capital riesgo del bufete Araoz y Rueda, explica las utilidades y diferencias entre los dos mecanismos de protección principales –los de ajuste completo o full ratchet adjustment, y los de ajuste medio ponderado o weighted average adjustment- y presenta la posibilidad adicional de autorizar ciertos fraccionamientos de riesgo o carve-outs, en situaciones especiales y limitadas.

There are two main types of antidilution protection: weighted average antidilution protection and ratchet anti-dilution protection.

The full ratchet mechanism retroactively reduces the pre-money valuation of the company by converting the acquisition price of the initial shares to the lower share price of a later round, irrespective of the number of new shares issued at the lower share price. A typical full ratchet mechanism would work as follows. If new shares are issued by the company at a price lower than the price formerly paid by the PE investors in previous rounds, then the conversion price of the old shares is effectively decreased, or "ratcheted", down to the lower price. For example, if the PE investor paid €10 for each share in the first round and the company approved a second round at a price per share of €2, then the PE investor would receive five shares for each old share, even if the further round only represented an insignificant number of shares.

Full ratcheting may entail a significant dilution for the non-PE investors that can be even greater in subsequent rounds and that may adversely affect relations between shareholders if the non-PE investors were not fully aware of the implications of a full ratchet. For this reason, most founders and management teams will negotiate hard to avoid a full ratchet.

A fairer alternative to a full ratchet is the weighted average adjustment. A weighted average mechanism takes into consideration the price of the new shares, the price paid for the old shares, the total number of new shares issued and the total number of shares outstanding. The rationale underlying this more moderate mechanism is to reduce the conversion price in proportion to the actual number of shares currently outstanding and issued by the company.

The PE investors' conversion price is reduced to a lower number that takes into account the number of new shares issued in the new round to diminish the old conversion price to a number between the latter and the price per share of the subsequent round, taking into account the aggregate number of both old and new shares. Therefore, the PE investors will get more shares on conversion and the non-PE shareholders will be diluted equitably. The formula used to calculate the weighted average adjustment may vary from deal to deal, but a common form is as follows:

Finally, regardless of the type of antidilution protection negotiated between the PE investors and the rest of the shareholders, the parties should agree carve-outs from anti-dilution in certain specified circumstances. These carve-outs would allow the company to approve the issuance of new shares to employees or to implement ESOPs (Employee Stock Ownership Plans) without activating the anti-dilution protection in favour of the PE investors.

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