Anti-Dilution- Calculating the numbers

Anti-Dilution means protecting against the dilution, and is the fundamental right sought by the investors globally to protect their investments from dilution. With the present era of technology, start-ups, and investments, there is a race amongst the start-up founders to innovate and develop new ideas and the investors to look for promising start-ups in order to invest. However, the investors simultaneously look for certain rights to protect themselves from dilution against any future pricing, since such pricing of new businesses are based on the prototype, the pilot model or the traction in the business model of the start-up, and is all notional and entirely pertains to the business it could develop and earn, and not the actual revenue stream or profit earnings. The investment strategy that the investors undertake is to invest in the potential start-ups, publicize it, develop it so that it reaches a certain benchmark, and then re-invest, publicize and develop it and keep repeating this process, but every time at a higher valuation, thereby increasing the worth of the start-up.

In essence, the term Anti-Dilution signifies a situation wherein when a start-up or a company receives a further round of investment at a price per share that is lesser than the price the shares obtained in the earlier round of investment. Therefore, adding the anti-dilution rights in investment agreements protect the investors and the money they invested in the start-up and adjusting the same in the next round transpiring at a lesser valuation, also known as the down round.

These anti-dilution rights shall be calculated either by ‘Full Rachet’ or based upon ‘Broad Based Weighted Average Method’, where Broad Based Weighted Average Method is most commonly followed in the industry not only by start-ups but also by investors, since it averages the interests of both the parties.

This article focusses on the calculation matrix of both the abovementioned methodologies, which can be further understood on the basis of the following illustration:

1. The Company has a share capital amount of INR 1050000 constituting 105000 shares of INR 10 each with investment from the Investors of the amount of INR 5 million at the price of INR 1000 per share, with number of convertible shares issued to the investor aggregating to 5000 (5 million divide by 1000);
2. The Company is now going for a down round of INR 1.5 million at the pricing of INR 750 per share.

Anti-Dilution under Full Rachet

Anti-dilution protection with full ratchet method pertains to a situation where in a subsequent round of investment, the valuation of the company dips and the shares are issued at a price which is lower than the price paid by the existing investors of the company, then the price of the shares of the existing investors would be amended and altered to the price at which the new shares have been issued. While this method of anti-dilution protection may be the most favoured by the existing investors, the founders often suffer the collateral damage whose shares would be diluted disproportionately while the existing investors escape unscathed.

Basis the illustration above, the investment amount of INR 5 million shall be adjusted to the price of INR 750 per share. Accordingly, the number of shares to be issued to the investor shall be 6666 (5 million divide by 750), in place of 5000 shares which are already issued against the receipt of investment. The new number of the shares issued to the investor shall be 1666 (6666 minus 5000).

Anti-Dilution under Broad based Weighted Average Methodology

This method does not simply adjust the pricing of shares for issue of the new shares, but averages the pricing by taking into consideration the number of shares held by the current shareholders and the number of shares issued in the subsequent round of investment. In this method, the conversion price of the shares is fixed by taking into consideration the number of new shares issued, the shares outstanding before the issue of new shares, the price of shares held by the pre-existing investors, and the price at which the shares are being issued to the new investor.

This method helps in reducing the impact of dilution on the existing shareholders, and therefore, it is advantageous as well as equitable from the company's, as well as the investor's point of view. Apart from the broad based weighted average method, there is another method called narrow-based weighted average method which focuses solely on the outstanding shares of the company and excludes the convertible securities like stock options, preferred stocks, warrants etc., which are included in the broad based weighted average method and is rarely used in the transactions.

The broad based weighted average anti-dilution formula is as follows:

$CP_2 = CP_1 \times [(A)+(B \div CP_1)] \div (A+C)$

Where, CP_2 = New Conversion Price

CP_1 = New Investors' Price ÷ Existing Investors' Price

A = No. of Shares outstanding prior to down round/ new issue

B = Total consideration from the down round/ new issue

C = Number of new shares issued

Now, applying the above methodology in the abovementioned illustration to calculate the number of new shares to be issued pursuant to the down round:

Variable	Meaning	Numbers (INR)
CP_1	New Investors' Price ÷ Existing Investors' Price	750 ÷ 1000 = 0.75
A	No. of Shares outstanding prior to new issue	105000
B	Total consideration from new issue	1.5 million
C	No. of Shares issued in new issue	2000 (1.5 mn ÷ 750)

$\mathbf{CP_2 = CP_1 \times [(A)+(B \div CP_1)] \div (A+C)}$

$CP_2 = 0.75 \times [105000+(1500000 \div 0.75)] \div (105000+2000)$

$CP_2 = 0.75 \times 2105000 \div 107000$

$\mathbf{CP_2 = 14.75}$

No. of shares to be allotted to the Existing Investor (including IS_0) = $IS_0 \times (CP_1 \div CP_2)$

Where, for illustration purposes,

IS_0 = no. of Shares already issued to Existing Investor = 5000

No. of shares to be allotted = $IS_0 \times (CP_1 \div CP_2)$

= 5000 × (0.75 ÷ 14.75)

= 254

Such adjustment of shares, whether by way of a full ratchet or weighted average method, can be given effect to, by adjustments to the conversion price. However, there are other mechanisms to such adjustments including: (a) issuance of additional shares at the prevailing price for free to the existing investor, (b) transfer of additional shares from founder(s) at the lowest permissible price to the existing investor.

Alternatively, the investors may also adopt the mechanism to block such down rounds as opposed to exercising anti-dilution rights. As a typical early-stage protection, anti-dilution provisions are usually available to an investor for a limited number of years or across limited investment rounds, after which the industry expects the investors to absorb dilutive issuances as a business risk.

Conclusion

While the full ratchet is most favoured by the existing investors who escape unaffected, where founders suffer collateral damage through disproportionate dilution. However, it has a deterrent effect on the new investors looking to invest in subsequent rounds as it gives enormous protection to the existing investors. On the other hand, the broad based weighted average method is beneficial for the company and the new investors since this methodology averages out the down round across parties, and thus is more preferred by the companies and the investors in an investment transaction.

Anti-Dilution with the foreign investor- A legal impediment.

The NDI rules as enacted by the Government of India read with the Master Directions on the foreign direct investments issued by the Reserve Bank of India, under Foreign Exchange Management Act 1999, provides for the issuance of the equity instruments to the foreign investor at a value which is not less than the fair value of such equity instruments. The underline object of which is the foreign investors to pay the fair value as the minimum value for any equity instrument acquired, and since such investor has invested in equity, it shall be participating in both profits and losses. Thus, the Anti-dilution rights which is a protection against the loss to the equity instruments or the down round is prohibited to the foreign investor. Therefore the foreign investor to look for other rights or modes to protect its investments.

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