LakeBridge

InFocus

Corporate Finance – Venture Capital

Why do founders often end only with a tiny portion of the exit proceeds?

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About LakeBridge

LakeBridge is an international corporate finance and financial advisory firm based in Switzerland.

It specializes in international corporate finance transactions and private solutions to entrepreneurs, family-owned companies and family offices.

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Entrepreneurs are key players of economic development. Risk taking, including reputational risk in case of failure, financial commitments, and the personal efforts required during several years should reward founders in a significant way.

Evidence suggests however that following a series of financing rounds, founders may find themselves owning just a dismal share of their businesses (as opposed to other investors such as venture capitalists or private investors).

If such situations are normally triggered by financial results missing their targets, the high levels of founders' dilution that may follow are to be explained by other factors. The pressing need for fresh capital combined with the lack of experience of founders in financial, structuring and contractual matters often lead to such situations.

Let's take a closer look at a few of these factors:

1. Too optimistic financial forecasts

Too conservative financial forecasts may not be compelling enough to attract investors; too optimistic, they may seem unrealistic and unattainable. Financial forecasting is a tricky exercise and even more so at young companies.

Entrepreneurs often tend to underestimate the time and costs involved in deploying their business strategies. Investors at their side tend to subject their investments to the achievement of specific milestones. In case these are missed, investors may decide not to participate in future financing rounds or penalise entrepreneurs through anti-dilution rules.

2. The impact of a loss in value between two rounds of financing "down round" (anti-dilution rules)

In a financing round, the "natural" dilution of founders resulting from the arrival of new investors may be accentuated when the capital increase takes place at a price per share lower than the one paid at a previous financing round. Anti-dilution provisions will protect existing investors to the detriment of founders.

In venture capital, the allocation of the exit proceeds between founders and investors is not necessarily proportional to the share capital percentage ownership.

In a down round, different adjustment mechanisms will allocate the loss in value between existing investors and founders in a different way.

3. The rights to a liquidation preference in case of a liquidity event

In an exit, the allocation of the exit proceeds will not be necessarily proportional to the percentage ownership.

First because investors normally hold preferred shares entitling them to their original investment amount before any payments can be made on the company's common stock (priority liquidation preference). Second, in addition to priority liquidation preferences, preferred shares may also bear participating liquidation preferences. On the one side of the spectrum, investors having participated in the last round of financing have priority in recovering their invested amounts. On the other side, founders hold common shares and are the last to receive exit proceeds. This common practice mechanism may lead to a big disparity in the allocation of the exit proceeds between founders and investors.

Simplified case - as illustration only (see graphic next page)

Just for the sake of illustration, we have developed two scenarii: one with and the other without a loss in value (down round) between the first and the second rounds of financing. Everything else remaining the same, in both scenarii there are two situations, one of with more severe anti-dilution and liquidation provisions than the other.

We've analysed the impact on the founders' share of the exit proceeds. In this example it ranges from 36.4% to 9.6%, highlighting the importance to founders of structuring the transaction adequately and modelling precisely the consequences of a selected option.

For illustration purpose only