STEPHENSON HARWOOD (SINGAPORE) ALLIANCE

July 2020

Down rounds and anti-dilution provisions

The Covid-19 outbreak and the resulting market downturn has had a significant adverse impact on valuations across several sectors in Southeast Asia. As companies look to raise additional rounds of financing in this new environment, “down rounds” or fund raising at valuations lower than in previous rounds of fundraising are expected to increase.

Down rounds will usually trigger anti-dilution rights attached to convertible securities that most venture capital funds have used when investing in their portfolio companies in Southeast Asia.

In certain jurisdictions in the region where investments in certain sectors may be subject to foreign equity limitations, such as in Indonesia, we have seen private equity and other foreign investors also structure their investments using convertible securities, which could entitle them to anti-dilution protection as well.

Anti-dilution rights typically operate either:

- by reducing the conversion price of convertible securities, resulting in a proportionate increase in the number of ordinary shares issuable to the investor upon conversion, or
- less commonly in Southeast Asia, by issuing additional shares to the investor at no or nominal consideration to achieve the same result.

Any adjustment of the conversion price could affect the voting and dividend rights of the shareholders as well, as preferred shareholders, for instance, usually vote and sometimes even receive dividends, on an "as converted" basis.

In this briefing note, we will discuss the common anti-dilution mechanisms and certain issues that investors and issuers need to keep in mind when structuring and implementing these provisions.

Anti-dilution mechanisms

Broad based weighted average adjustment

This involves applying a mathematical formula to proportionately reduce the conversion price of existing convertible securities based on the number of shares and subscription amount raised in the down round.

Consequently, a greater number of securities issued at a lower price will result in a larger anti-dilution adjustment.

The two common formulas used for this purpose are as follows:

Option 1

New Conversion Price	=	then prevailing Conversion Price immediately prior to the dilutive issue x Weighted Average
Weighted Average	=	$\frac{(A + B)}{(A + C)}$
A	=	the number of ordinary shares (on a fully diluted, as converted basis) immediately prior to the dilutive issue
B	=	the aggregate consideration received by the company for the new securities issued in the dilutive issue, <u>divided by</u> the Conversion Price immediately prior to the dilutive issue
C	=	the number of new securities issued in the dilutive issue

Option 2

New Conversion Price	=	$\frac{(A \times B) + (C \times D)}{(B + D)}$
A	=	then prevailing Conversion Price immediately prior to the dilutive issue
B	=	the number of ordinary shares (on a fully diluted, as converted basis) immediately prior to the dilutive issue
C	=	the price of new securities issued in the dilutive issue
D	=	the number of new securities issued in the dilutive issue

Note that the number of ordinary shares of the company outstanding prior to the dilutive issue in the above formulas is calculated on "a fully diluted, as converted basis", which typically includes shares reserved for issuance under stock option plans and issuable pursuant to the exercise of outstanding warrants and other convertible securities of the company.

By increasing the number of outstanding shares in this manner, the effect of a dilutive issue (and the resulting anti-dilution adjustment) is reduced.

As such, holders of ordinary shares would typically like to include as many shares as possible in calculating the number of ordinary shares outstanding prior to the dilutive issue, while the holders of convertible securities who would benefit from an anti-dilution adjustment would typically like to include as few shares as possible.

This leads us to a variation of the broad based weighted average adjustment – the narrow based weighted average adjustment.

Narrow based weighted average adjustment

As noted above, a narrow based weighted average adjustment would reduce the number of ordinary shares outstanding prior to the dilutive issue by considering only ordinary shares in issue and issuable upon the conversion of preference shares (while excluding the ordinary shares issuable upon the exercise of any options and warrants).

This method is however far less common in venture capital deals in Southeast Asia than the broad-based approach.

The “Full Ratchet”

This is a far simpler approach than the weighted average adjustments described above, and is the most favorable to the holders of convertible securities. However, it also has the most adverse effect on the holders of ordinary shares.

This requires a company to revise downwards the conversion price of existing convertible securities to the lowest price per security issued in the down round.

Since we disregard the size of the dilutive issue, it can cause a disproportionate dilution of the stakes of the other non-protected shareholders.

For the above reasons, full ratchets are rarely used, although we have seen them in deals in Southeast Asia with inexperienced or poorly advised founders.

Adjustments for non-price based dilutive events

Holders of convertible securities are also typically protected from non-price based dilutions on account of share splits, share consolidations or share dividends.

In addition, structural changes to the capital of a company on account of transactions such as share swaps, mergers and re-organizations could also adversely affect holders of convertible securities.

It is not possible to include specific formulas for anti-dilution protection on account of all of the foregoing. Parties typically address this by providing that in case of such events, the board or the shareholders shall recalculate conversion prices to ensure that no party is better or worse off, and in case of disputes, the matter would be referred to an expert to resolve.

In addition, such events are usually reserved matters that require the approval of a specified threshold of directors or shareholders. This acts as a further check on unreasonable behavior by certain parties.

Other issues to consider

Exceptions to anti-dilution clauses

Parties typically negotiate specific exceptions to provide for issuances of securities that will not trigger anti-dilution provisions. These typically include shares issued pursuant to the exercise of share options or pursuant to warrants or other convertible instruments that are already outstanding on the issue date of the relevant convertible instruments.

Alternatively, parties may also exclude the operation of anti-dilution provisions to issuances that are specifically approved by a prescribed number or category of shareholders. This provides the company with a degree of flexibility in such matters without requiring the approval of every shareholder that may potentially be affected, particularly in respect of companies that have a large number of minority shareholders.

Price of the dilutive issue

Where companies have issued multiple series of preference shares, it is possible that a dilutive issue may constitute a down round only in respect of certain later series of preference shares and not in respect of certain earlier series of preference shares that may have been issued at a substantially lower valuation. In such instances, only the holders of such later series of preference shares should be entitled to anti-dilution adjustments.

It is possible that the same investor may hold preference shares of different series with different conversion prices, and the anti-dilution adjustments will therefore have to be calculated separately.

Further, if the conversion price of any convertible instruments issued by the company can only be determined in future, then anti-dilution rights may be triggered only upon such determination.

Issue of additional shares

As noted previously, another approach to anti-dilution that parties sometimes adopt involves the issue of additional preference or ordinary shares at no consideration upon a down round to the investors entitled to such protection, without changing the conversion price of their convertible instruments.

The formulas described above in the context of broad based weighted average adjustments can also be used, with some variations, to determine the number of such additional shares to be issued. This approach is often a less attractive option as it could potentially lead to several issues, including the following:

- The shareholders entitled to anti-dilution protection will want preference shares to be issued as such additional shares, while the company will prefer to issue ordinary shares instead. Issuing additional preference shares could increase the liquidation preference for such shareholders beyond the amount they have actually paid at subscription, and this may be resisted by the company and ordinary shareholders.
- Since no additional consideration is payable, the company will have to issue such bonus shares by capitalizing profits or reserves. In a down round scenario, the company may not necessarily have sufficient profits or reserves, or it may not be practicable to capitalize them. Such capitalization would also, in most jurisdictions, require the approval of shareholders, and would therefore require the cooperation of the relevant shareholders.
- Where adequate reserves or profits are not available to be capitalized, the shareholders entitled to such shares may be required to pay a nominal consideration to acquire such additional shares. This could have implications in certain jurisdictions in Asia where there are restrictions on the issue of shares to foreign shareholders at less than fair value.
- Making re-adjustments would be more difficult. For example, if new options exercisable at a down round price are never exercised and lapse, non-protected shareholders would want the anti-dilution adjustments to be reversed. This can be easily reversed when adjusting the conversion price. However, it would be more complicated to do so where shares have already been issued to compensate the protected shareholders.

Anti-dilution provisions offer valuable protection to investors, particularly in case of a down round following a severe decline in valuation. There are various options investors can use in this regard, but as noted above, it is important for parties to recognise the implications of each of these options.

Please note that the information contained here is only a brief summary of relevant issues and is not a substitute for specific legal advice.

For more information, please do not hesitate to contact any members of the team listed in the following page.

Get in touch

George Cyriac
Partner

T: +65 6622 9692
E: george.cyriac@shlegal.com

Widya Rianita
Associate

T: +65 6622 9567
E: widya.rianita@shlegal.com

Stephenson Harwood is a law firm of over 1100 people worldwide, including 180 partners. Our people are committed to achieving the goals of our clients – listed and private companies, institutions and individuals.

We assemble teams of bright thinkers to match our clients' needs and give the right advice from the right person at the right time. Dedicating the highest calibre of legal talent to overcome the most complex issues, we deliver pragmatic, expert advice that is set squarely in the real world.

Our headquarters are in London, with nine offices across Asia, Europe and the Middle East. In addition we have forged close ties with other high quality law firms. This diverse mix of expertise and culture results in a combination of deep local insight and the capability to provide a seamless international service.

The Stephenson Harwood (Singapore) Alliance is part of the Stephenson Harwood network and offers clients an integrated service in multi-jurisdictional matters involving permitted areas of Singapore law.

STEPHENSON HARWOOD (SINGAPORE) ALLIANCE