Venture Best

June 04, 2020

When “Flat” Means “Up” and Maybe “Down” Does Too

With the chill of the pandemic taking hold in the venture capital business, we are beginning to see more “flat” and “down” rounds. That is, new rounds of financing at a share price equal to (the “flat” round) or lower than (the “down” round) than in the prior round of financing.

Funny thing about flat rounds: while the per share price of the shares issued in a flat round is the same as that of the prior round, the “pre-money” valuation of the company – the number that usually drives the deal valuation discussion between the company and the investors – is actually higher than it was in the preceding round. And so, flat rounds are actually up rounds from a different perspective.

A simple example will illustrate how “flat” can be “up” by another name.

Suppose Joe Entrepreneur owns 1 million shares of NewCo. Jane Investor now buys 1 million new shares of NewCo for $1 million in an “A” round. The price per share is $1.00. The post-money valuation is now $2 million (Jane bought half of NewCo for $1 million, so NewCo is valued, post the transaction, at $2 million). The pre-money for the round was thus $1 million (the post-money less the amount invested).

Life goes on for a bit, and NewCo needs another $1 million of fresh capital. Along comes Alex Investor who invests $1 million at $1.00 per share in a “B” round. The B round is a “flat” round in industry parlance because the price/share is the same as the prior round.

But consider that the post-money on the B round is $3 million (Alex bought a third of NewCo for $1 million, so NewCo is now valued at $3 million). And the pre-money for the B round is now $2 million (the post-money less the amount invested). So, while the B round was “flat” in terms of share price, in terms of pre-money valuation the B round is twice the pre-money value of the A round. And thus, the flat B round is also an up round.

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You can, in any given flat round scenario, do the math to see how “up” a “flat” round is, or you can employ a simple rule: the pre-money in a flat round is equal to the post-money in the prior round, which, in turn, is just the pre-money in the prior round plus the amount invested in the prior round.

If you extend the logic, you can see how even a “down” round can be an “up” round. In the above example, what if the B round is at $0.80/share, a significant drop from the $1 of the A round? Well, here’s the math. Alex gets 1,250,000 shares for his $1 million, and post-closing there are 3,250,000 shares outstanding. So, Alex owns 1.25/3.25 of NewCo, or 38.4 percent. That means the post-money is $2.6 million (1/.384 * $1 million), and the pre-money is $1.6 million ($2.6 million less the $1 million invested). So, you’ve got a down round ($0.80 is down from $1.00) that is also an up round (the $1.6 million pre-money of the B round is up from the $1.0 million pre-money of the A round).

Now a lot of this “confusion” is a combination of semantics and tricks of the trade. But it also conveys something significant. A “flat” round does not mean that NewCo has not made progress since the prior round. Rather, it means that NewCo’s “return on capital” from the prior round was zero – not positive, *but also not negative*. NewCo did not add any value to the capital invested by the A round investors, but neither was any value subtracted from that investment. *The A round investors were diluted, in terms of ownership stake, but the value of their that stake is unchanged*.

The above analysis suggests that, perhaps in lieu of a new flat round, entrepreneurs and investors should consider simply extending the prior round: that is, raising fresh capital via the old deal terms and documents. You get the same result, presumably easier and cheaper than you would if you had to work through a whole new set of documents.

As it turns out, if the new round will in fact be funded entirely by the prior round investors, pro-rata, the extension of the prior round makes a lot of sense. To the extent, though, that the investments will come, in whole or in part, from new investors – or that the current investors will not all be taking their pro rata share of the new deal – the round extension option will be problematic. Specifically, the new and over-weighted investors in the new deal will want to make sure their “last money in” is positioned, in the deal’s liquidation preferences, as the “first money out.” That is, they will want to make sure they have the first crack at the proceeds in any exit transaction, prior and in preference to investors in earlier rounds.

So if you find yourself, as entrepreneur or investor, looking at a flat round over the coming months, look at it this way: with all the pandemic turmoil and carnage, you at least held your ground.

Related People

Paul Jones
Of Counsel
pajones@michaelbest.com
T 608.283.0125

Paul Jones
Of Counsel
pajones@michaelbest.com
T 608.283.0125

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