VC Lexicon

Anti-dilution Protection (also known as Anti-dilution provisions): In the event of a down-round financing (i.e. when new convertible preference shares are issued at a lower price than an earlier round), existing preferred shareholders with anti-dilution protection are compensated through the adjustment of the conversion ratio from preference to ordinary shares. Common formulae used are:

i. Broad-based Weighted Average Anti-dilution:

$CP_2 = CP_1 * (A+B) / (A+C)$

CP_2 = Series A Conversion Price in effect immediately after new issue
CP_1 = Series A Conversion Price in effect immediately prior to new issue
A = Number of Ordinary Shares outstanding immediately prior to new issue (includes outstanding ordinary shares, all shares of outstanding preference shares on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing)
B = Aggregate investment in new round of financing divided by CP_1
C = Number of shares of stock issued in the new round

Broad-based Weighted Average Anti-dilution Example:

Techco raised two rounds of financing:
Series A round of $5.00m at $1.00/share and Series B round of $8.00m at $0.80/share.

Post Series A Investment:

Shareholder	Investment	Price/Share	Preference Shares	Conversion Price/Share	As Converted to Common Shares	Ownership
Ordinary					20.00m	80.00%
Series A	$5.00m	$1.00	5.00m	$1.00	5.00m	20.00%
Total					25.00m	100.00%

Post Series B Investment (Series A without Anti-Dilution):

Shareholder	Investment	Price/Share	Preference Shares	Conversion Price/Share	As Converted to Common Shares	Ownership
Ordinary					20.00m	57.14%
Series A	$5.00m	$1.00	5.00m	$1.00	5.00m	14.29%
Series B	$8.00m	$0.80	10.00m	$0.80	10.00m	28.57%
Total					35.00m	100.00%

Post Series B Investment (Series A with Broad-based Anti-Dilution):

Shareholder	Investment	Price/Share	Preference Shares	Conversion Price/Share	As Converted to Common Shares	Ownership
Ordinary					20.00m	56.65%
Series A	$5.00m	$1.00	5.00m	$0.9429	5.30m	15.02%
Series B	$8.00m	$0.80	10.00m	$0.80	10.00m	28.33%
Total					35.30m	100.00%

ii. Narrow-based Weighted Average Anti-dilution:
Uses the same formula as Broad-based Weighted Average Anti-dilution except for variable A which is redefined more narrowly:

A = Number of Ordinary Shares outstanding immediately prior to new issue (only includes all preference shares on an as-converted basis for the series being adjusted)

Narrow-based Weighted Average Anti-dilution Example:

Post Series B Investment (Series A with Narrow-based Anti-Dilution):

Shareholder	Investment	Price/Share	Preference Shares	Conversion Price/Share	As Converted to Common Shares	Ownership
Ordinary					20.00m	55.91%
Series A	$5.00m	$1.00	5.00m	$0.8667	5.769m	16.13%
Series B	$8.00m	$0.80	10.00m	$0.80	10.00m	27.96%
Total					35.769m	100.0%

iii. Full Ratchet Anti-dilution:
The conversion price will be reduced to the price at which the new shares are issued.

Full Ratchet Anti-dilution Example:

Post Series B Investment (Series A with Full Ratchet Anti-Dilution):

Shareholder	Investment	Price/Share	Preference Shares	Conversion Price/Share	As Converted to Common Shares	Ownership
Ordinary					20.00m	55.17%
Series A	$5.00m	$1.00	5.00m	$0.80	6.25m	17.24%
Series B	$8.00m	$0.80	10.00m	$0.80	10.00m	27.59%
Total					36.25m	100.0%

*** The Number of Series A shares does NOT change. Only the Conversion Price and hence the Conversion Ratio (Preference A to Common) changes.**

Board Observer: Board Observers have the right to be present at meetings of the board of directors and be informed of any decision of the board of directors but do not have the right to vote in board decisions.

Conversion: Preference shares that are issued to a venture capital investor are convertible to ordinary shares at any time at the option of the investor according to a conversion ratio. The shares are hence called *Convertible Preference Shares*. The initial conversion ratio at the time of investment is 1 preference share to 1 ordinary share but is subject to adjustments for share splits, consolidations, issue of share dividends, recapitalizations and anti-dilution provisions. Preference shares are subject to automatic conversion to Ordinary shares in the event of a qualifying IPO.

Cumulative Dividend: A dividend which accrues to the next period if not paid in the current payment period. This dividend could be a fixed value or a percentage of the share's original price to be remitted periodically to shareholders irrespective of the earnings or profitability of the company. Conversely, a non-cumulative dividend does not accrue if not paid (or declared). Dividends to preferred shareholders must be paid prior to any dividends to ordinary shareholders.

Director: Directors are appointed by shareholders of the company and make crucial company decisions such as the appointment of key managers like the CEO, COO, CFO, and the issuance of dividends. Together as a board, the directors make key decisions about the company such as fundraising and sale of the company. Often, these major decisions are included under Reserved Matters and hence further subject to Protective Provisions which require the approval of shareholders (as explained under Reserved Matters or Protective Provisions below).

Drag-Along Right: In the event of an offer for all the shares of the company, Preferred shareholders owning more than a certain threshold percentage (negotiated and determined at time of investment) who agree to sell can require all other shareholders to sell their shares on the same price and terms.

Fully-diluted Basis: Fully-diluted shares refer to the total number of outstanding Ordinary Shares assuming all convertible securities (including preference shares, warrants, convertible notes, and stock options) are converted.

Indemnity: An indemnity is security for potential loss or an exemption from liability for damages based on a contractual agreement made between two parties. The losses or damages incurred by one party will be paid by the other set out in the contract.

Investment Agreement (also known as Subscription Agreement): An agreement to subscribe for a new issuance of security. The Investment Agreement describes the type of security, the price and the terms and conditions relating to the subscription.

Liquidation or Liquidity Event: In the context of a Term Sheet or Shareholders' Agreement for an illiquid security, a liquidation or liquidity event triggers the rights of Preferred Shareholders to exercise their Liquidation Preference. Hence, the definition of a liquidation or liquidity event is extremely important and specifically defined in the legal document. As an IPO (Initial Public Offering) on an exchange triggers the automatic conversion of Preferred Shares to Ordinary, an IPO does not cause the exercise of liquidation preference and hence is excluded as a liquidation event for holders of Preferred Stock. However, an IPO is considered a liquidity event for holders of CARE documents as it can trigger the issue of Ordinary Shares or repayment.
Typically, a liquidation or liquidity event for Preference Shareholders includes:

i. A liquidation, dissolution or winding up of the Company.

ii. A consolidation or merger of the Company with or into any other corporation or corporations or non-corporate business entity or any other corporate reorganization in which the shareholders of the Company immediately prior to such consolidation, merger or reorganization, own less than majority of the surviving or acquiring entity's voting power immediate after such consolidation, merger or reorganization.

iii. A sale, lease, transfer, exclusive license or other disposition of all or substantially all of the assets of the company

iv. A transaction or series of transactions in which more than 50% of the voting power of the Company is transferred.

Liquidation Preference: Preferred Shareholders are entitled to exercise their liquidation preference rights upon the occurrence of a liquidation or Liquidity Event as defined above. A liquidation preference is the amount that must be paid to each series of preferred shareholders before distributions may be made to ordinary shareholders. The ranking of different series of preferred shareholders, the value as well as type of liquidation preference are often subjects for negotiation.

- **Ranking:** Later series of preference shares can rank above earlier series or rank pari passu or any other order as negotiated and recorded in the Shareholders' Agreement.

- **Value:** The liquidation preference value is often expressed as a multiple of the original purchase price per share such as 1x, 2x etc.

- **Type:** Liquidation preference rights can be classified as:

i. <u>**Non-participating Liquidation Preference:**</u>
Upon the occurrence of a liquidation or liquidity event, preferred shareholders will have to choose either to exercise their liquidation preference rights i.e. receive a multiple of their initial investment amount (1x, 2x etc. as stipulated in their liquidation preference rights) **OR** convert their preference shares to ordinary (according to the prevailing conversion ratio) and receive a

share of the proceeds according to their equity ownership of the company. Hence, preferred shareholders will choose whichever option maximizes their payout.

ii. **Participating Liquidation Preference:**
Upon the occurrence of a liquidation or liquidity event, preferred shareholders will first receive a multiple of their initial investment amount (1x, 2x etc. as stipulated in their liquidation preference rights) **AND** in addition, receive a share of the proceeds together with ordinary shareholders as if they had converted their preference shares to ordinary.

Liquidation Preference Payout Example:

Techco raised two rounds of financing:
Series A round of $5m at $1/share with 1x **non-participating** liquidation preference and
Series B round of $18m at $3/share with 1x **participating** liquidation preference
Series B ranks ahead of Series A which ranks ahead of ordinary.
Management of Techco owned 9m ordinary shares.

Post Series B capitalization:

Shareholder	Investment	Price/Share	No Shares	Ownership
Series B	$18m	$3	6m	30%
Series A	$5m	$1	5m	25%
Ordinary			9m	45%
Total			20m	100%

Techco was acquired 2 years post Series B for $98m. Payout:

Shareholder	Liquidation Pref	As Converted to Common	Exit Returns
Series B	$18m	$24m	$42m
Series A		$20m	$20m
Ordinary		$36m	$36m
Total	$18m	$80m	$98m

Series B shareholders will receive their liquidation preference of $18m and also receive a share of the remaining proceeds on an as converted to ordinary basis (30% of $80m) amounting to $24m for a total exit return of $42m. Series A shareholders will choose to convert their shares to Ordinary and receive (25% of $80m) $20m. Ordinary shareholders will receive the remaining $36m.

Ordinary Shares (also known as Common Stock): Ordinary Shares are typically issued to founders, management, and employees. Ordinary shareholders rank below debt holders and preferred shareholders in terms of liquidation preference and are not entitled to preferential rights accorded to holders of Preferred Stock.

Preference Shares/Preferred Stock: Preferred Shareholders are entitled to certain preferential rights (such as liquidation preference, anti-dilution protection etc.) over and above ordinary shareholders. These rights are subjects for negotiation and stipulated in the Term Sheet and ensuing legal documents such as the Shareholders' Agreement. Unlike preference shares in public companies, preference shares in private companies held by venture capital funds are convertible to ordinary shares and come with voting rights and may even include seats on the Board.

Pre-money Valuation: The value of the company immediately before the current round of investment.

Post-money Valuation: The value of the company immediately after the current round of investment.

- Post-money Value = Pre-money Value + Investment into Newly Issued Shares

Redemption Right: Depending on negotiation, preference shares may come with the right to sell the shares back to the company usually after a specified period (typically more than 3 years) at the original purchase price plus a specified rate of return.

Reserved Matters or Protective Provisions: Refer to certain key decisions that require the concurrence of (i) a predetermined percentage of preferred shareholders voting either as a Series of Preferred shareholders (each voting as a class) or all Preferred shareholders voting together as a class or (ii) directors appointed by the holders of Preferred Stock(if applicable). The percentage of preferred shareholders that must agree is subject to negotiation and can vary for each Series.

- **Key decisions included under Protective Provisions can vary and often include but are not limited to :**

  i. A sale of the company or other "Liquidation Event"

  ii. Any amendment to the company's Certificate of Incorporation that alters or changes the powers, preferences or special rights of Preferred Shareholders

  iii. Any increase or decrease (other than by conversion) in the total number of authorized shares (Preferred or Ordinary)

  iv. The authorization or issuance of any equity security having a preference over, or being on a parity with, any series of Preferred Stock with respect to dividends, liquidation or redemption

  v. The redemption or purchase of Preference or Ordinary Shares (subject to certain exceptions)

  vi. Any declaration or payment of any dividends or any other distribution on account of any Preference or Ordinary Shares

  vii. Any change in the authorized number of directors of the company

  viii. Any hiring, firing or change in the compensation of any key executive officers of the company.

Pre-Emption Rights over New Issuances: A contractual right of Preferred Shareholders to purchase new issuance of shares in subsequent rounds of financing on a pro-rata basis.

Right of First Refusal: In the event of a sale of shares by an existing shareholder to a third party, other shareholders may exercise their right of first refusal by matching the price offered by that third party. If matched, the seller is then bound to sell the shares to the other shareholders on a pro-rata basis.

Series A: First round of financing led by a venture capital or institutional investor. The shares issued would be Series A Preference Shares, hence the name Series A round. Typically the company would be in the product design and development stage. Successive rounds of funding are then termed Series B, Series C and so forth.

Tag-Along Right (also known as co-sale rights): Refers to the right of preferred shareholders to sell their shares alongside the Founders and/or other shareholders (owning more than a specified percentage of the company) on a basis proportionate to the amount of securities held by the seller and those held by the participating Investors. It should be noted that Founders/Key Managers are often subject to a lock-up or restriction on the sale of their shares.

Warranty: A warranty is a contractual assurance from a seller to a buyer. Depending on the agreement, warranties can cover a wide range of matters including but not limited to ownership of shares, licenses and intellectual property, validity of financial reports, quality and performance of products and compliance of employment regulations. A party that breaches a warranty is responsible for the loss and damage that is foreseeable as a result of the breach.