



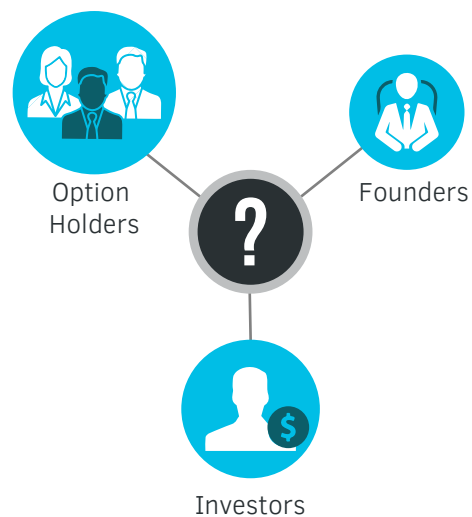
NAVIGATING WATERFALLS

ASSESSING THE IMPACT OF FUTURE FINANCING
ROUNDS ON THE FAIR VALUE OF, AND EXIT-PROCEED
DISTRIBUTIONS TO, EXISTING EQUITY SECURITIES

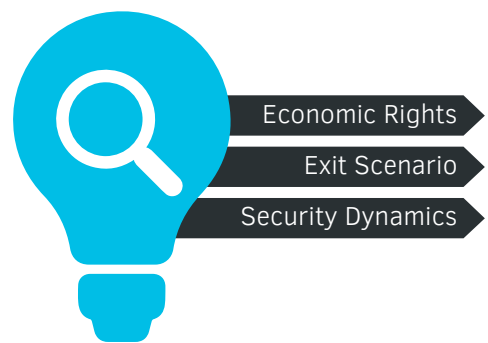
I was recently contacted by a CFO who was in the process of negotiating a bridge round of financing for a prominent SaaS company targeting an IPO in the relatively near future. The round was being led by an inside investor (i.e., one who already held preferred equity in the firm). In efforts to further expedite the funding, the investor was offered very favorable terms on the preferred stock, accompanied by a number of warrants to purchase additional shares, which number would increase along with the amount invested. This deal was attractive to the company, as it secured the funds needed to launch a new business line for which time was of the essence. The deal was also attractive to investors, as they received a sizable increase in their equity holdings in a company that was very likely to achieve a successful exit.



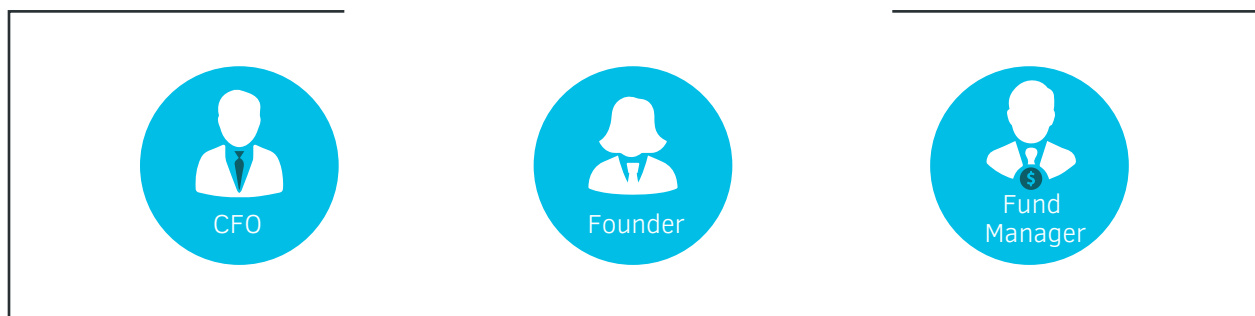
On the other hand, management was concerned with the extent to which founders or other employees with equity holdings would be adversely impacted by dilution resulting from the exercise of the incentive warrants. To offset this potential impact, management planned to increase the size of the company option pool and to issue a number of options to those most affected by dilution in order to make them whole. But to what extent were the founders and the other employees impacted? How would a distribution to these shareholders differ in an exit event in absence of the warrants? How many options must be issued to minimize, or even eliminate, the value lost due to dilution?



The somewhat irksome answer to all these questions, as is often the case in the world of finance, is that it depends. With multiple rounds of preferred stock (each of which may have differing economic rights) and multiple option grants at differing exercise prices, the capital structure of later-stage companies can be quite complex. A proper analysis requires a detailed understanding not only of the economic terms of the individual securities but also of how the terms of any given security class may impact the distribution to other security classes. Further complicating the matter is that when it becomes advantageous for an option holder to exercise, barring cashless exercise provisions, the holder must pay the exercise price—this leaves additional exercise proceeds available for distribution, on which the exercised option holders also have a partial claim. Lastly, the quantity of make-whole options needed will differ depending on the exit proceeds available for distribution as well as the type of exit (distributions may differ in an IPO relative to an acquisition).



Whether you're a CFO in a similar position to that described above, a founder trying to weigh the ramifications of competing financing offers, or a fund manager seeking to maximize returns, the structure of an investment can have a substantial impact on both the present value of a particular security—important for financial reporting, option grants, etc.—and future distributions available to the holder of any equity security.



Here at Scalar, in order to address these issues, we've developed sophisticated models that can be tailored to any cap table, no matter the level of complexity. We provide highly customized, dynamic, and user-friendly models to clients that enable them to make the optimal financing or investment decisions when faced with any number of alternatives. In short—our analysts are kind of awesome. Whatever your situation, when it comes to evaluating the ramifications of any financing or investment decision in privately held companies, we've got you covered.

