Embracing Down Rounds: A Potential Path to Long-Term Equity Value

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KEY TAKEAWAYS

- Managed properly, a down round can be preferable to managing cash burn as a way to keep revenue and equity value growth on track over the long run
- For companies with strong unit economics and business models, the cost of dilution from a down round can pale versus the potential value created by sustained revenue growth in the medium to long term
- The dilutive effect of a down round on existing shareholders can be mitigated by provisions that recalibrate conversion rates for preferred shares
- The estimated percentage of down rounds was 14.2% of completed financings in the US in 2023, the highest since 2017, according to PitchBook

Introduction

In the landscape of startup financing, down rounds — when new shares are sold at a lower valuation than in the immediate prior capital raise — have traditionally been viewed with apprehension by companies and investors alike.

Historically, down rounds have been associated – often wrongly – with companies that are struggling or in distress, which can lead to decreased employee morale, dilution of existing ownership, and a challenging path forward. However, a bull market fueled by low interest rates has created a unique landscape in which many strong businesses carry much higher valuation multiples than comparable public companies, even on a growth-adjusted basis. We are therefore seeing a chain reaction in which new financings with clean terms become more difficult to achieve. As a result, many founders and boards are opting to reduce burn – and hence potentially hampering revenue growth – to avoid a valuation markdown.

But getting past the negative connotations and outdated misconceptions of down rounds, and utilizing a lower valuation as a tool to secure financing with clean terms, can help a business to continue growing, often more quickly, while potentially achieving superior long-term equity value creation.

The Value of Down Rounds

Contrary to common perceptions, down rounds can be an opportunity to create significant equity value for shareholders, including founders and existing investors. Down rounds can provide the capital necessary to fuel continued strong growth. Opting instead to reduce burn can dramatically curtail growth. Another alternative is to raise a flat, structured round of financing. However, in our experience, that can potentially create misalignment between founders and investors, or be overly punitive in the long term.

Taking a down round, while carefully managing the impact on existing shareholders, can help keep revenue and equity value growth at a rate that matches, or even exceeds, current levels

For companies with strong unit economics and business models, we contend that the cost of dilution from a down round will often pale versus the value created if the company is able to achieve higher sustained revenue growth in the medium to long term.

Mechanics of Down Rounds

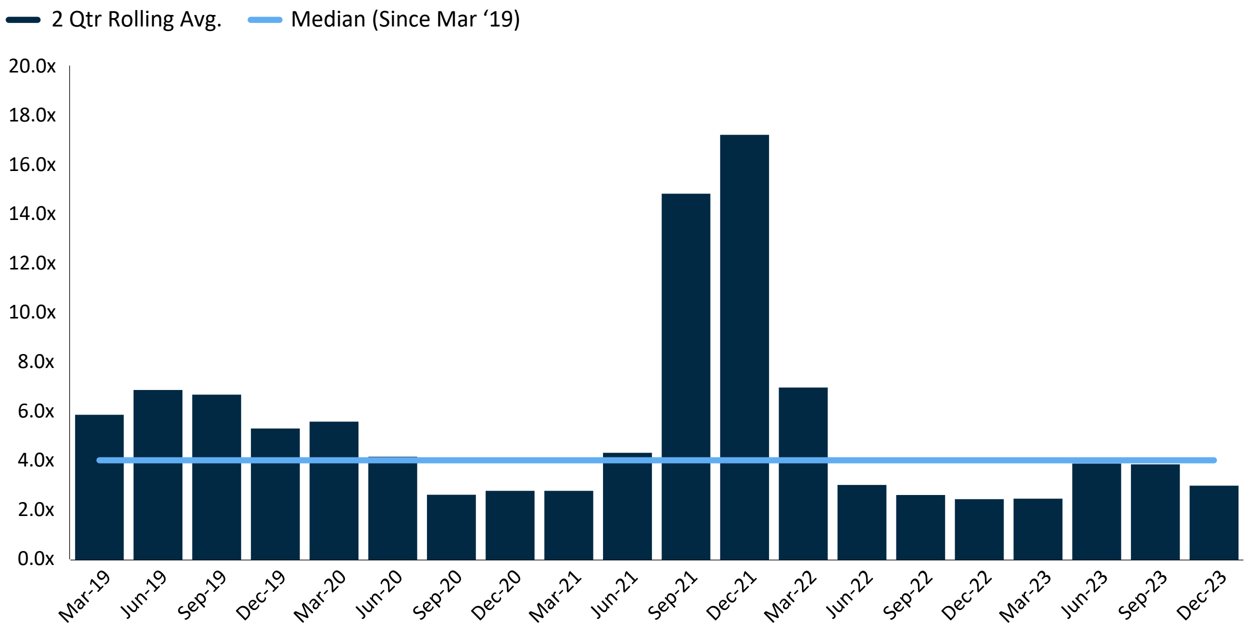
In the context of a down round, dilution occurs as existing shareholders' percentage ownership decreases due to the issuance of new shares at a lower valuation. But the dilutive effect experienced by earlier investors can be mitigated by provisions that recalibrate conversion rates for existing preferred shares in the event of a down round. The silver lining from the bull market of the past decade or more has been a shift towards cleaner, founder-friendly term sheets, with "broad based" anti-dilution provisions becoming relatively standard. These mechanisms are more favorable to founders than alternatives, such as a full ratchet anti-dilution clause.

Growth vs. Profitability

Prioritizing growth over profitability has become the key point of debate. Traditional metrics such as the Rule of 40 – under which the sum of a company's growth rate and free cash flow margin should exceed 40% – have been instrumental in guiding this balance.

However, public markets assign more weight to growth relative to free cash flow margins, with a unit of revenue growth driving significantly more equity value than a unit of profitability. This underscores the compounding value of scale, even at the expense of short-term profitability. The correlation of growth to valuation, particularly prevalent in the software sector, demonstrates that markets reward high-growth companies with premium valuations. Figure 1 shows the relative importance of next 12 month (NTM) revenue growth vs NTM free cash flow for publicly traded software companies. While the relative importance fluctuates based on the market, revenue growth has consistently been the more important indicator of value in recent years.

Figure 1: Relative Importance: NTM Rev vs. NTM FCF (Rolling 2-Qtr Avg.)[1]



Consider two hypothetical examples in Figure 2. In the first hypothetical, a company opts to manage burn over raising a down round, lowering growth. Under the second scenario, the same company raises a Series B at a 50% discount to the series A price per share and is able to grow revenue at a more durable rate.[2]

Figure 2: Hypothetical Examples[2]

Series A Assumptions	
Price Per Share	$10
Series A Investor Shares	20

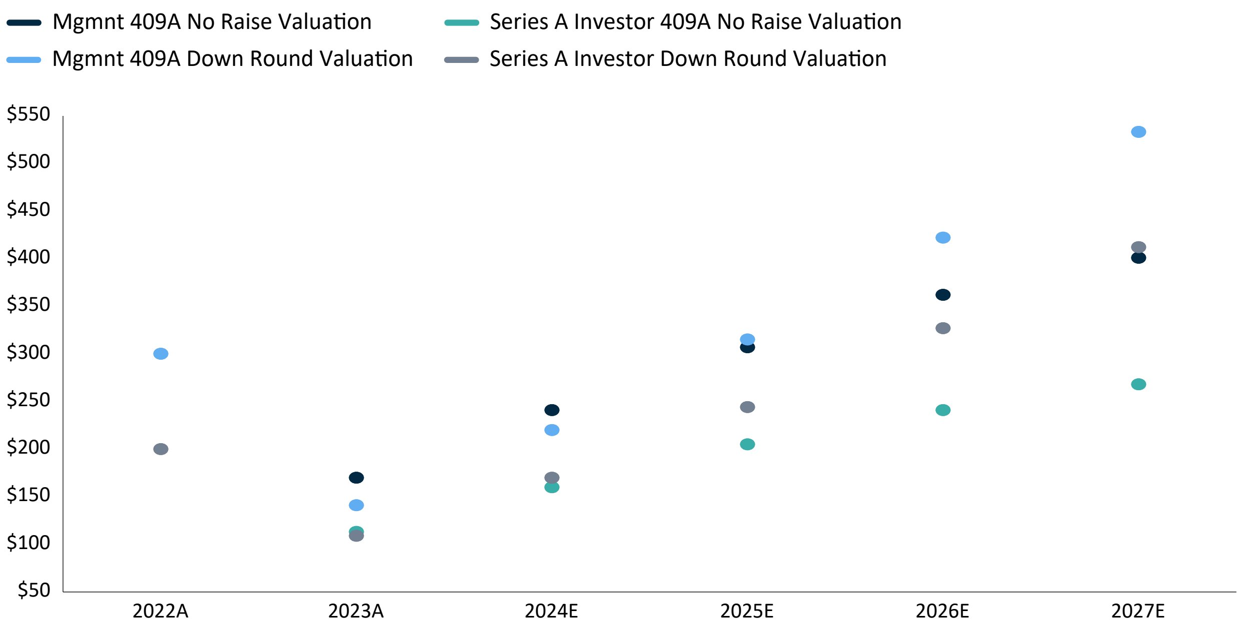
Series B Assumptions	
Price Per Share	$5
# of New Shares Issued	10

	Series A					
No Cap Raise/Slower Growth	2022A	2023A	2024E	2025E	2026E	2027E
Revenue	$20	$34	$51	$68	$84	$99
Revenue Growth (YoY)	100%	70%	49%	34%	24%	17%
Last Round Post Money	$500	$500	$500	$500	$500	$500
Implied Revenue Multiple	25.0x	--	--	--	--	--
409A Value of Equity	$500	$283	$401	$512	$603	$669
New Round Investment	--	$0	$0	$0	$0	$0
Mgmnt. Ownership	60%	60%	60%	60%	60%	60%
Series A Ownership	40%	40%	40%	40%	40%	40%
Series B Ownership	--	--	--	--	--	--
Mgmnt. 409A Value Equity	**$300**	**$170**	**$241**	**$307**	**$362**	**$401**
Series A 409A Value Equity	**$200**	**$113**	**$160**	**$205**	**$241**	**$268**

	Series A	**Series B**				
Downround/Fast Growth	2022A	2023A	2024E	2025E	2026E	2027E
Revenue	$20	$36	$59	$89	$126	$167
Revenue Growth (YoY)	100%	80%	64%	51%	41%	33%
Last Round Post Money	$500	$300	$300	$300	$300	$300
Implied Revenue Multiple	25.0x	8.3x	--	--	--	--
409A Value of Equity	$500	$300	$467	$671	$899	$1,134
New Round Investment	--	$50	$0	$0	$0	$0
Mgmnt. Ownership	60%	47%	47%	47%	47%	47%
Series A Ownership	40%	36%	36%	36%	36%	36%
Series B Ownership	--	17%	17%	17%	17%	17%
Mgmnt. 409A Value Equity	**$300**	**$141**	**$220**	**$315**	**$422**	**$533**
Series A 409A Value Equity	**$200**	**$109**	**$170**	**$244**	**$327**	**$412**

The simulated valuation tradeoffs for these competing scenarios are shown in Figure 3.[3] While the near-term equity value for the Series B scenario is impaired, "Mgmnt 409A Down Round Valuation" and "Series A 409A Investor Down Round Valuation" show that, given our assumptions and the anticipated impact on revenue from investment of capital, the medium- and long-term equity value for both management and investors is better in the down round scenario.[4] Our hypothetical scenario shows that based on the modelled pricing and number of shares issued in the Series B, management's equity value takes a hit in 2023 and 2024 before becoming more valuable in 2025 and beyond, while the trough and recovery for Series A investors is less pronounced due to broad-based anti-dilution mechanisms being assumed here.[5]

Figure 3: Valuation Tradeoffs[3]



Strategies for Managing Down Rounds

So when determining whether raising a down round or managing burn until valuations rise is the better option, founders and executives should carefully assess the balance between immediate needs and long-term objectives. Founders and executives should have open, transparent discussions with potential and existing investors, as this can lead to more favorable terms, including the adjustment of anti-dilution provisions and the minimization of dilutive effects.

Secondly, under appropriate circumstances, such as when a business displays strong unit economics, sacrificing near-term profitability and investing new capital in achieving higher long-term revenue growth can create equity value. While unit economics vary by industry and sector, they generally follow principles around time to pay back customer acquisition cost; profit margins after variable expenses; and customer lifetime. The stronger the unit economics, the more return on investment incremental spend provides to equity value.

Long-Term Thinking

The number of down round financings is rising. According to PitchBook, in the third quarter of 2023 the estimated percentage of down rounds in the US climbed to a 10-year high of 17.1%, up from 13.5% in the prior three months,[6] while the figure for the whole of 2023 was 14.2% of completed financings, the highest since 2017.[7] It was a similar picture in Europe, where 21.3% of deals in 2023 were down rounds, compared with 14.4% in 2022.[8] Companies should therefore not automatically reject the idea.

Focusing on managing available cash can adversely impact value creation in the long run by reducing the ability to properly invest in the systems and talent needed to keep growth on track. Taking a down round, while carefully managing the impact on existing shareholders, can help keep revenue and equity value growth at a rate that matches, or even exceeds, current levels.

As companies that have raised down rounds know from experience, there doesn't need to be a stigma from taking this path. Indeed, in the long run, the alternative may turn out to be significantly worse. ■

1. Source: CapitalIQ. Data compiled quarterly from a basket of 80 publicly traded SaaS companies
2. For illustrative purposes only. Values chosen by Adams Street and are hypothetical as a variety of factors may impact the revenue growth achieved by a company and available financing is only one component; while potentially correlated, available financing and revenue growth are not necessarily dependent or indicative. There can be no guarantee that the hypothetical values shown here are representative of the growth that would be experienced by any company or subsequent returns that would be achieved by any investor as projections or forward-looking statements are only estimates. The use of graphs, charts, formulas, or other devices are subject to inherent limitations and difficulties; investors should not make investment decisions, including whether to purchase or sell or the timing of such actions, based solely on the information presented in such devices.
3. Ibid
4. Ibid
5. Ibid
6. Source: PitchBook "US VC Valuations Report Q3 2023", November 8, 2023, Page 10
7. Source: PitchBook "2023 Annual US VC Valuations Report", February 7, 2024, Page 26
8. Source: PitchBook "2023 Annual European VC Valuations Report", February 10, 2024, Page 10