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RATCHETS IN VENTURE CAPITAL DEALS

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Typically, venture capital ('VC') investors expect to obtain an exit within a 3-7 year period and target a minimum return of their investments. Rights and mechanisms designed to allow the VC firms to protect their investment value, gain liquidity and maximise the returns need to be properly set out in the investment documentation.

A ratchet in a VC deal is a mechanism whereby a shareholder's equity stake may be increased (or decreased) on the occurrence of certain events.

Basically, an equity ratchet arrangement is designed to result in the percentage of the investment vehicle's equity represented by the investor's shares varying according to the performance of the company, rising in case of underperformance and falling when the institutional investor's returns reach a particular target figure. This issue is often prominent during pricing negotiations as the VC investors will always have a more conservative approach to the management's naturally optimistic performance forecasts.

While management may view anti-dilution provisions such as ratchet arrangements as unfair or too onerous, VC investors will seek to include such provisions to protect the economic value of their investments in the event of a down round (ie a round of financing in which the valuation of the company is lower than that determined by investors in a previous round). In fact, this is not the only resource available to the VC investors keen to ensure that they do not pay too much for their stake in the company: liquidation preferences that provide preferential treatment for their shares in the event of liquidation of the company or a sale of a majority of the company's stock will certainly be part of the investment protection package.

As an incentive or bonus, a ratchet will usually operate to increase management's shareholding if the venture performs particularly well and results in a successful exit for the VC investor. It is a device which permits the management team to obtain a higher equity stake if performance exceeds expectations and the VC investor obtains on exit more than the agreed internal rate of return ('IRR') or multiple of its investment. The IRR for an investment is the interest rate at which the total present value of future cash flows equals the cost of the investment. In other words, it is the interest rate that produces a zero net present value. Full details of the arrangement will be set out in a shareholders agreement or in the articles of association. The tax and legal implications as regards the way in which a positive ratchet for the management is implemented should be considered carefully as the tax and legal environment and the specific circumstances of both the target company and potential beneficiaries may change during the live of the investment.

The calculation of IRR, as a protection for the VC investor, is justified on the grounds that traditional methods of valuation (such as discounted cash-flow and market comparables) cannot be applied to companies or ventures at an early stage. The percentage acquired by the VC investor is based on the pre-money valuation of the company (ie the valuation prior to financing) as agreed with the company. In determining the pre-money valuation, the VC

investor will analyse the projected value of the company and the percentage of this value that will provide it with its required rate of return on a fully diluted basis.

There are two common types of price protection - a full ratchet and a weighted average ratchet - which will take effect when, for example, shares are issued to new investors at a price lower than that paid by the original VC investors. The most onerous form for management is the full ratchet, which results in the early ratchet-protected VC investors being issued with additional "free" shares so that the effective share price of their shares equals the lower share price of the new round. On the other hand, the basic approach to the weighted average ratchet is to adjust the conversion price to the average price received by the company for its various stock issuances.

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