Venture Financing Series · Part 3 of 3

Anti-Dilution Protection: How a Down Round Reallocates Pain Across the Cap Table

The formula, the denominator, and the carve-outs that actually determine the outcome

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The previous article in this series asked who gets paid first when the company is sold. This one asks who gets diluted first when the company has to raise again on worse terms.

In preferred financings, anti-dilution is not a fairness clause. It is a formula for reallocating the damage of a down round. When a company raises new capital at a lower effective price per share than earlier investors paid, anti-dilution protection adjusts the economics of the earlier preferred stock. That adjustment does not come out of nowhere. It comes primarily out of the common — which usually means the founders, common holders, and the employee equity pool.

At a technical level, anti-dilution is usually a conversion-price mechanism. The investor is not simply handed a fresh block of shares because the company had a bad round. Instead, the conversion price of the protected preferred is adjusted so that each preferred share converts into more common than before. That is where the economics move.

Full Ratchet: History Gets Rewritten at the New Price

Full Ratchet is the harshest standard form of anti-dilution protection. If an earlier investor bought preferred shares at $10 per share and the company later sells stock at $5 per share in a down round, Full Ratchet effectively rewrites the earlier investor's historical entry price to $5 for conversion purposes. Stock that previously converted one-for-one into common may now convert two-for-one.

What makes Full Ratchet so aggressive is that it ignores the size of the new financing. A small bridge round at the lower price and a very large round at the lower price both reset the earlier investor's conversion price to the new, lower number. In balanced venture financings, Full Ratchet is not the market baseline. It is a stress term.

Weighted Average: The Formula Still Protects, But Measures the Size of the Wound

Weighted Average also protects the earlier investor against a lower-priced round, but it adjusts the conversion price by reference not only to the new lower price, but also to the size of the new issuance relative to the company's existing capitalisation. It looks at both price and volume.

A $3 million down round at $5 per share and a $30 million down round at $5 per share do not produce the same anti-dilution adjustment under a weighted-average formula. Weighted Average does not eliminate the pain. It allocates it more proportionally.

The Real Fight: Broad-Based vs Narrow-Based

Weighted Average is not one thing. It comes in two materially different versions: Broad-Based and Narrow-Based. The difference sits in the denominator — and the denominator is where much of the economic severity gets decided.

Broad-Based Weighted Average uses a broader measure of the company's capital structure — common, preferred on an as-converted basis, options, warrants, and other convertible equity. Larger denominator = smaller adjustment = more founder-friendly.

Narrow-Based Weighted Average uses a smaller denominator — a narrower slice of the preferred capital structure. Smaller denominator = sharper adjustment = more investor-favourable.

"Weighted average" on its own is not a conclusion. It is the start of the negotiation.

Carve-Outs: Not Every Issuance Should Trigger the Adjustment

Anti-dilution protection should not apply to every issuance of securities. Modern financings typically carve out categories of exempt issuances — equity granted under approved employee equity plans, certain strategic issuances, equipment or bank financing warrants, and other specifically negotiated categories. These carve-outs are part of the term, not exceptions to it.

A concrete risk: suppose the investor requires the company to refresh the option pool as part of the down round. If the carve-out is not drafted properly, the very equity refresh demanded as a condition to the financing can itself feed into the anti-dilution mechanics — deepening dilution on the common side through the investor's own financing conditions.

What Founders Should Do Before They Sign

In a balanced round, the founder's target is usually clear: avoid Full Ratchet, push for Broad-Based Weighted Average, read the denominator carefully, and treat carve-outs as a real economic term rather than boilerplate.

Before signing, press for a concrete numerical analysis. Ask:

- What exactly triggers the adjustment?
- What sits inside the denominator?
- Which issuances are exempted?
- How does the formula behave in a smaller down round versus a larger one?
- Where does the dilution actually land — on founders, employees, the unallocated pool?

Ask to see the cap table before and after the adjustment. Ask what happens under at least two scenarios. If the answer is verbal rather than numerical, the analysis is not finished.

Anti-dilution should not be negotiated as a label. It should be negotiated as a formula, a denominator, and a set of carve-outs.

Something in this article applies to your situation?

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