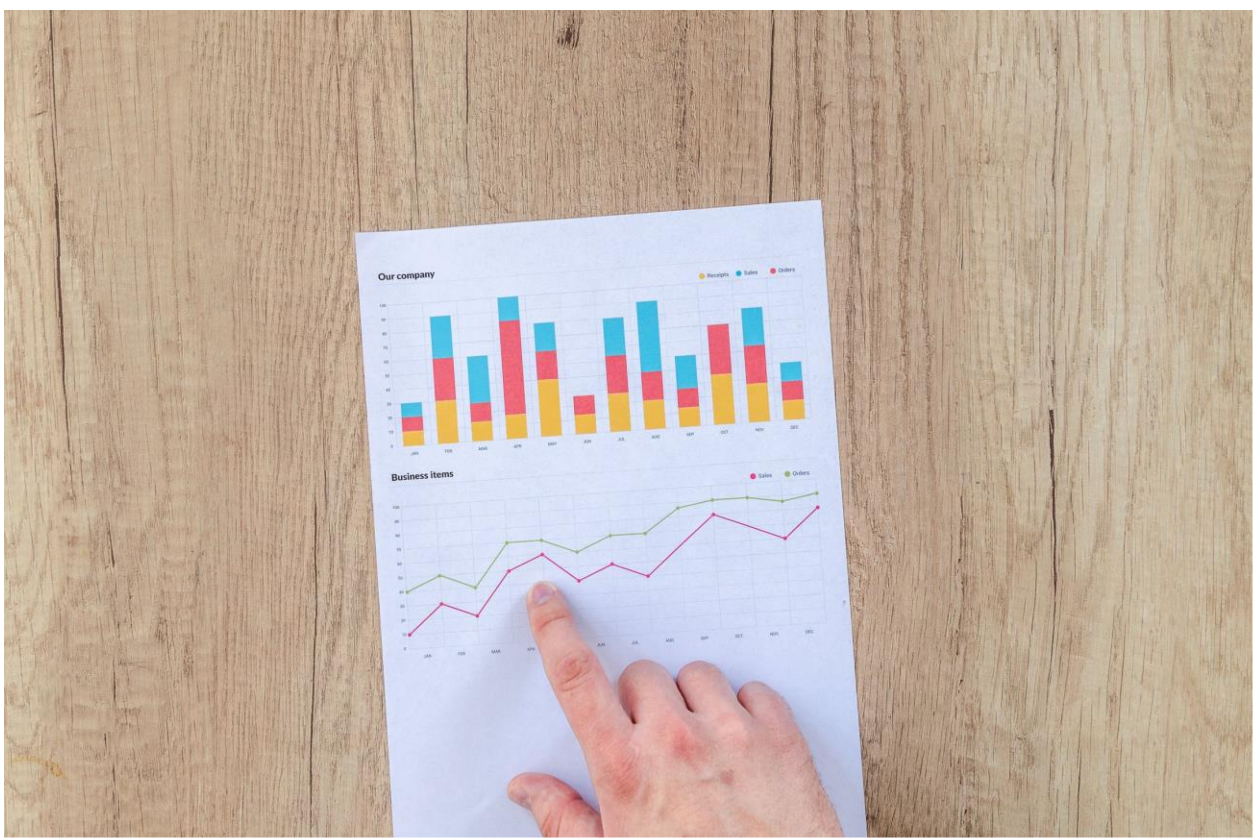


Down Rounds: Dirty Words That Aren't That Big of a Deal

by Dennis Hammer

Ideally, your startup's valuation should raise between each round of funding. You should use early investments to fund operations and growth so the company is worth more the next time you ask VCs for money.

This means that your family, friends, and Series A investors will pay pennies for their shares compared to later investors. VCs who invest late don't enjoy the same return as your early investors.

At least that's how it's *supposed* to work.

Sometimes a startup's valuation *decreases* between funding rounds. When the company looks for funding again, they experience a **down round**.

In this article, we're going to talk about why startups fear down rounds and why that fear is a *bit* misguided.

1. What's Wrong with a Down Round?
2. Why You Shouldn't Be Afraid of Down Rounds
3. Down Rounds Are Better Than Dying

What's Wrong with a Down Round?

A down round is when private investors purchase equity in your startup at a lower valuation than the previous round.

How does a valuation decrease? There are several possible reasons:

- Poor company performance / failure to meet benchmarks
- New competition in the space
- Stock market decline (meaning less overall investment)
- Personnel issues (inability to retain talent, drama, etc.)
- Unreasonably lofty initial valuations

Down rounds are a source of panic for many startup founders. It's actually the subject of one of HBO's episodes of Silicon Valley. In the episode, the startup's CEO is counseled to reject a generous funding offer because the valuation was too high. He fears he won't be able to match or beat the initial investment in subsequent rounds, triggering a dreaded down round. Check it out:

<iframe width="560" height="315" src="https://www.youtube.com/embed/c8NWriCa3rQ?start=97" frameborder="0" allow="autoplay; encrypted-media" allowfullscreen></iframe>

Psychology plays a role in investing, even for professional investors who try to be objective.

VCs prefer oversubscribed companies. That is, they want to invest in companies where the demand for shares exceeds the supply. Your company is more attractive to investors if other investors are interested.

This isn't a VC-specific phenomenon. People want to invest in what's popular because they're afraid of missing out.

As a startup, you also want your company to be oversubscribed. You want VCs to try and buy more than you're willing to sell. That means there's a demand for your shares and you can sell them for top dollar.

But if you *aren't* a highly sought-after company, and you're forced to raise money at a lower valuation than your previous round, future investors and talent become leery.

A down round signals that something is wrong with the company. Maybe something didn't go according to plan. Maybe the leadership can't execute at that high of a level. Maybe the market doesn't need that product.

It's tough to explain your way out of a lower valuation. You could try to convince VCs that you raised money on the upward swing of a bubble, but that doesn't really change the fact that the company is worth less now than it was before.

If you don't get the valuation you like, you can just go to another VC, right?

It's not that simple. There are fewer than 100 active tech VCs in the USA. There might be a few more when you factor in hedge funds, seed funds, and angel investors, but there still aren't that many *people* doing it.

It's a tight-knit industry where news spreads quickly. If you can't get a valuation *at least* equal to your last funding round, people find out. This compounds your "undesirable-ness."

Plus, most VCs have plenty of potential deals on their desks. Why take the risk on a company that wasn't able to grow their valuation when there are more optimistic options?

Employees don't like down rounds either. Early team members often join the company for common stock ownership. They trade some of their personal risk for equity.

Typically, VCs negotiate for *preferred* stock with anti-dilution protection. When you sell stock in a down round, investors who bought in the previous round get *more* stock so their shares won't be diluted. At the end of it all, the *common* stock owned by employees ends up losing value.

Basically, down rounds reduce the compensation your team expects to cash out later. That can be a big problem for employees who invested their time in your company expecting a big payout down the road.

Additionally, the down round investors often get friendly funding terms. Shares sold in down rounds often come with a senior liquidation preference, meaning those shares get paid out first (possibly at a multiple). Down round investors sometimes also ask for board seats or power to make certain decisions.

That all may sound scary, and they're certainly good reasons to avoid down rounds. But if you're stuck accepting a lower valuation, it doesn't mean your startup is doomed.

Why You Shouldn’t Be Afraid of Down Rounds

First, a down round isn’t the end of your company. It’s not even necessarily the sign of struggle. Plenty of startups carry on just fine after a down round.

In fact, check out this list of 152 tech companies that accepted a down round since 2015: Downround Tracker. You’ll recognize many of those companies because they’re still around today – and many of them are quite large and successful. Most had wildly successful exits, either acquired by other companies or went through a public offering.

Second, the startup investment world is going through a natural adjustment. All markets do it. We’re seeing an increase in down rounds and fewer unicorns.

The “cooling” of the venture capital market began back in 2015 and became significant in quarter two of 2016.

Up, Down and Flat Rounds

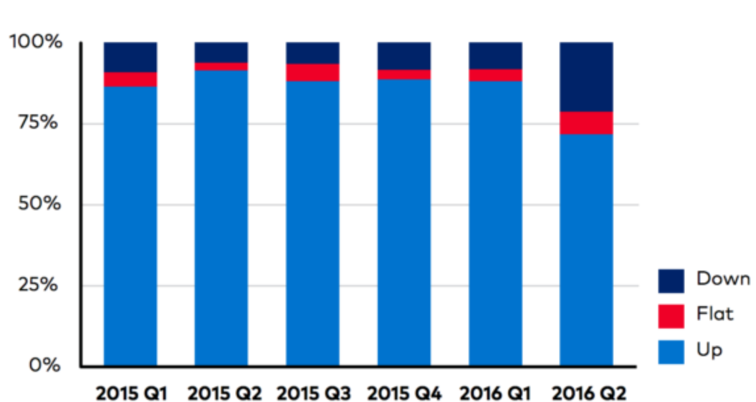
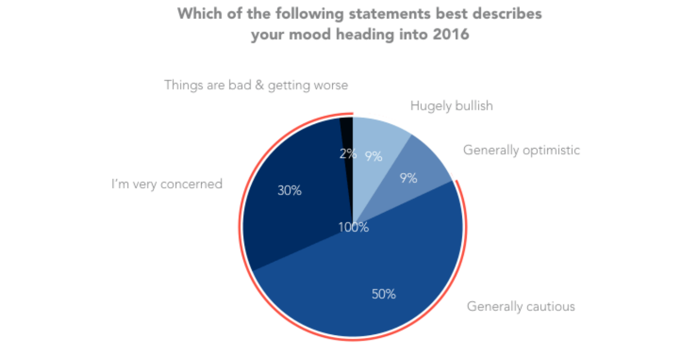


Image: geekwire.com

According to Cooley’s Q2 2016 Venture Financing Report, down rounds made up 21% of all startup deals in Q2 2016. That’s nearly triple the previous two quarters.

Back in 2015, Upfront Ventures surveyed more than 150 VCs from all stages and geographies. The survey asked, "Which of the following statements best describes your mood heading into 2016?" 82% expressed *caution* or *concern* about the future.

With the sentiment of the markets it's no surprise that a full 82% of VCs expressed caution or concern going into 2016



22 Source: Upfront Survey Jan 2016, 155 VCs. upfront

Image: [inc.com]

The increase in down rounds was predictable, too. 61% of VCs surveyed (remember, this was back in 2015) reported that prices had begun to drop, and 91% expected prices to continue to drop.

More than 90% of respondents in the Upfront VC Survey expected valuations to go down in 2016 with a full 1/3rd of investors expecting significant price corrections

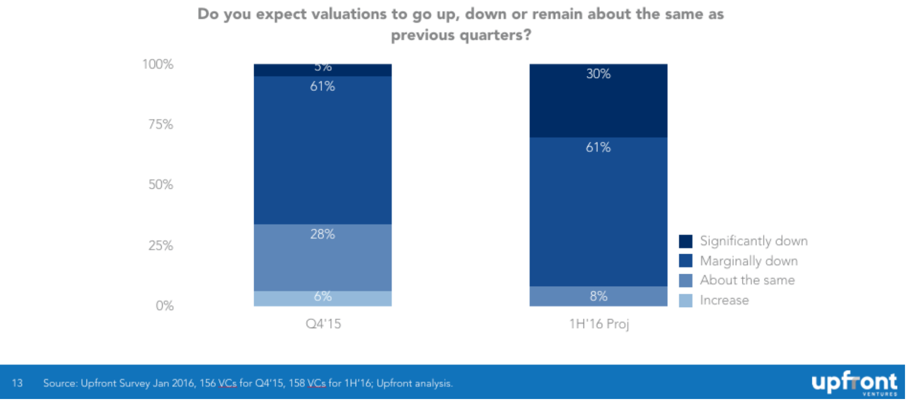


Image: [inc.com]

Most importantly, you shouldn't be frightened of down rounds because they mean you're *still able to raise capital.* People still want to buy your company. You must be doing something right.

"Although a down round will dilute your economics, no venture has ever died from excess dilution," [says VC attorney Dror Futter]. "The same cannot be said for lack of funds."

Down Rounds Are Better Than Dying

Naturally, it's better to accept a lower valuation than refuse funding. The closer you are to the end of your runway, the less leverage you have with investors.

Investment legend Ben Horowitz says it well:

"If you are burning cash and running out of money, you are going to have to swallow your pride, face reality, and raise money even if it hurts. Hoping that the fundraising climate will change before you die is a bad strategy because a dwindling cash balance will make it even more difficult to raise money than it already is, so even in a steady climate, your prospects will dim."

Avoid raising money at a lower valuation than your last round if you can. But if you can't avoid a down round, raise what you can and move on. There's still plenty of opportunity for success!

Need some advice about funding or valuations? Join the 10xU community for advice specific to your unique situation.