▾ DOWN ROUND ALERT

CAP TABLE MASTERCLASS · PART 2 OF 4

When the *Market Turns*

Down rounds, anti-dilution protection, pay-to-play, the recap — and how to survive each one with your company and your dignity intact.

Company	Where We Left Off
NovaSpark, Inc.	Series B · $155M valuation

Narrator	Audience
The CFO	The Founder CEO

CHAPTER 01

The Down Round: What It Is and Why It Happens

In Part 1, every round was an up round. Each time new investors wrote a check, they valued NovaSpark more than the last investor did. The price per share went from $1.00 at Seed to $2.80 at Series A to $5.76 at Series B. Everything moved in one direction: up.

Now I am going to tell you what happens when the world stops cooperating. Because it will. Not always, not to every company — but to enough of them that every founder needs to understand this cold, the same way a pilot needs to understand what to do when an engine fails. You do not want to be learning the procedure while the plane is going down.

A **down round** is any new funding round where the price per share is *lower* than the price per share in the previous round. That is the only definition that matters. It does not mean the company is worthless. It does not mean you failed. It means the new investors believe the company is worth less today than the previous investors believed it was worth when they invested.

FIFTH-GRADER ANALOGY

Remember our pizza? In Part 1, each time a new partner joined, they paid more per slice than the last partner. The first investor paid $1 per slice. The second paid $2.80. The third paid $5.76. A down round is when a new partner shows up and says: "I will only pay $3.50 per slice. I think you overpriced it." The existing partners who paid $5.76 are not happy. Their slices are now worth less than they paid. This is called being "underwater" or "out of the money."

Why Down Rounds Happen

There are three common causes, and they can arrive alone or together. Understanding the cause matters because the cure is different for each.

1

The Company Missed Its Numbers

You told Series B investors you would hit $20M ARR. You hit $11M. Growth slowed. Churn increased. The business is not performing as projected, and new investors will pay for the business you have, not the business you promised.

2

The Market Changed

Interest rates spiked. A recession hit. The IPO window closed. Public market SaaS multiples dropped from 20× ARR to 6× ARR. Private markets follow public markets with a 12–18 month lag. Even if your business is perfectly healthy, its valuation gets marked down because the entire category repriced. This happened across the board in 2022–2023.

3

You Raised at an Inflated Valuation

Sometimes founders accept money at a price that was too high — driven by FOMO, a hot market, or aggressive investors. When that valuation is not grown into, the next round brings the price back to earth. The down round is simply a correction.

> *"A down round is not a death sentence. It is a reset. The founders who survive it are the ones who understand the mechanics before they need to use them."*
>
> — THE CFO TO THE FOUNDER

CHAPTER 02

NovaSpark's Down Round: The Setup

Let me remind you where we stand after the Series B.

SHAREHOLDER	SHARES (FD)	% FD	PRICE PAID / S
You (CEO / Founder)	5,000,000	18.6%	$0
Priya (CTO / Co-Founder)	3,000,000	11.1%	$0
Employees + ESOP Pool	6,048,000	22.5%	var
Redwood Ventures (Seed)	2,500,000	9.3%	$
Apex Capital (Series A)	4,286,000	15.9%	$
Meridian Growth Partners (B)	6,076,000	22.6%	$
TOTAL	26,910,000	100%	

Post-Series B, NovaSpark was valued at **$155 million** and the share price was **$5.76.** Now fast-forward eighteen months. The macro environment has deteriorated. SaaS multiples have compressed. NovaSpark's ARR grew to $14M (below the $22M target). Burn rate was high. You have four months of runway left. You need to raise.

After a painful five-month process, the best term sheet you can get is from a new investor, **Fortis Ventures**, willing to invest **$20,000,000** — but at a **pre-money valuation of $70,000,000.**

Series B-2 (Down Round) — Month 66

▼ Down Round

$70M PRE-MONEY (DOWN FROM $155M)	−55% VALUATION DROP
$90M POST-MONEY VALUATION	$2.60 NEW PRICE / SHARE*

The new price per share is approximately **$2.60** — compared to $5.76 at the Series B. Every investor who paid $5.76 (Meridian), $2.80 (Apex), and even $1.00 (Redwood at par) now has a complicated situation. Meridian is now deeply underwater. And this is where the legal machinery of the cap table starts to matter enormously.

DOWN ROUND — PRICE PER SHARE CALCULATION

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Pre-money valuation:            $70,000,000
Fully diluted shares (current):   26,910,000
New Price Per Share: $70,000,000 ÷ 26,910,000 = $2.601 per share
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Investment (Fortis Ventures):     $20,000,000
New shares issued: $20,000,000 ÷ $2.601 = 7,690,000 shares
Post-money total FD shares: 26,910,000 + 7,690,000 =
34,600,000

Series B investors paid:  $5.76 / share
New price:                $2.60 / share ← 55% underwater
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CHAPTER 03

Anti-Dilution Protection: The Clause That Changes Everything

Remember in Part 1, I mentioned that preferred stockholders get special rights? One of the most consequential of those rights is the **anti-dilution provision.** When you are raising money in good times, this clause sits quietly in your term sheet and nobody talks about it. When you raise a down round, it wakes up — and it can dramatically re-draw the cap table.

Here is the core idea. An investor who paid $5.76 per share made that bet based on the assumption that NovaSpark would be worth more in the future. A down round says: the company is worth less. The investor feels cheated. The anti-dilution clause is their contractual right to get some of that loss back — not in cash, but in **more shares.**

FIFTH-GRADER VERSION

You sold your friend a pizza slice for $5.76. Then you told everyone the pizza was only worth $2.60 per slice. Your friend says: "That is not fair. Give me extra slices to make up for what I overpaid." Anti-dilution is the legal agreement you made that says you will do exactly that.

There are two main types of anti-dilution protection. They produce very different outcomes. This is one of the most important things you will ever negotiate as a founder.

BROAD-BASED WEIGHTED AVERAGE

The most common and most founder-friendly form. The investor's conversion price is adjusted to a weighted average of the old price and the new price, taking into account the total number of shares outstanding. The adjustment is moderate and proportional. Most Seed and Series A deals use this. **Always push for this.**

NARROW-BASED WEIGHTED AVERAGE

Similar math but uses a smaller "base" of shares in the formula — essentially a smaller denominator — which gives the investor more protection (more extra shares). Less favorable to founders than broad-based. Occasionally seen in competitive deals.

FULL RATCHET

The nuclear option. The investor's conversion price drops all the way down to the new round's price — regardless of how many shares are issued in the down round. Even if only one share is sold at the lower price, the investor is made whole as if they had paid the new lower price all along. Devastating to founders. Rare in normal markets, sometimes seen in distressed situations or early-stage bridge deals.

Broad-Based Weighted Average: The Math

Let us work through what the anti-dilution adjustment looks like for Meridian Growth Partners (Series B), using the broad-based weighted average formula. This is the formula that matters most in practice.

BROAD-BASED WEIGHTED AVERAGE ANTI-DILUTION FORMULA

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New Conversion Price = CP₁ × (A + B) / (A + C)

Where:
CP₁ = Original conversion price (what investor paid) = $5.76
A = Total FD shares outstanding before new issuance = 26,910,000
B = Shares that would have been issued at OLD price for the new $
raised
= $20,000,000 ÷ $5.76 = 3,472,222
C = Actual new shares issued at the new (lower) price = 7,690,000
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New Conversion Price for Meridian:
= $5.76 × (26,910,000 + 3,472,222) / (26,910,000 +
7,690,000)
= $5.76 × 30,382,222 / 34,600,000
= $5.76 × 0.8781
= $5.058 new conversion price for Meridian
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Meridian originally invested $35,000,000 at $5.76 = 6,076,000 shares
After adjustment: $35,000,000 ÷ $5.058 = 6,919,000 shares
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Meridian receives: 6,919,000 - 6,076,000 = 843,000
additional shares
These 843,000 new shares dilute everyone else — mostly the founders.
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WHAT THIS MEANS FOR YOU

Meridian paid $5.76 and is partially compensated for the down round by receiving 843,000 extra shares at no additional cost. These shares come from the authorized but unissued pool. They do not cost Meridian anything — but they dilute your ownership and every other common stockholder. The anti-dilution adjustment is effectively a transfer of value from the founders to the preferred investors.

Full Ratchet: How Bad Can It Get?

Now let me show you the same scenario with a full ratchet provision instead. This is a teaching exercise — not something you should accept in a term sheet if you have any negotiating leverage.

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FULL RATCHET ANTI-DILUTION (COMPARISON)

Full Ratchet: Meridian's conversion price drops to the new round price
New conversion price = $2.60 (the new round price, period)

Meridian originally: $35,000,000 ÷ $5.76 =   6,076,000
shares
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After ratchet:       $35,000,000 ÷ $2.60 = 13,461,538
shares
Additional shares:  13,461,538 - 6,076,000 = 7,385,538
extra shares
Under weighted average: Meridian got 843,000 extra shares
Under full ratchet:  Meridian gets 7,385,538 extra shares —
8.8× more
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Your ownership would drop from 18.6% to approximately 11.2%
This is why full ratchet provisions are called "founder killers."
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BROAD-BASED WEIGHTED AVERAGE

Meridian receives 843,000 extra shares. Your stake drops from 18.6% to roughly 17.1%. Painful, but survivable. The company keeps operating. Your incentive to stay is intact.

FULL RATCHET

Meridian receives 7,385,538 extra shares. Your stake drops to roughly 11.2%. Your team's options go deeply underwater. Key employees start leaving. The company enters a death spiral.

CHAPTER 04

The Post-Down-Round Cap Table: All the Math, All in One Place

Let us now assemble the complete post-down-round cap table, incorporating the new Fortis Ventures investment and the anti-dilution adjustments for all three existing preferred investors. We are assuming all three have broad-based weighted average provisions, which is realistic.

We have already calculated Meridian's adjustment (843,000 extra shares). Now let us check Apex and Redwood.

ANTI-DILUTION ADJUSTMENTS — APEX CAPITAL (SERIES A)

Apex paid $2.80 per share. New round price is $2.60.

Apex IS underwater but only slightly ($2.80 vs $2.60).

CP_1 = $2.80, A = 26,910,000, B = $20M ÷ $2.80 = 7,142,857

C = 7,690,000

New price = $2.80 × (26,910,000 + 7,142,857) / (26,910,000 + 7,690,000)

= $2.80 × 34,052,857 / 34,600,000

= $2.756 new conversion price

Apex adjusted shares: $12,000,000 ÷ $2.756 = 4,354,000

Extra shares for Apex: 4,354,000 - 4,286,000 = 68,000 shares (minor)

ANTI-DILUTION — REDWOOD VENTURES (SEED)

Redwood paid $1.00. New price is $2.60. Redwood is ABOVE water.

No anti-dilution adjustment for Redwood. Their conversion price stays $1.00.

Anti-dilution only applies when new price is BELOW what the investor paid.

Series B-2 Down Round — Month 66

$20M raised · $70M pre-money · $90M post-money · $2.60 / share · Fortis Ventures · Anti-dilution triggered for Meridian & Apex

SHAREHOLDER	SHARE CLASS	SHARES (FD)
You (CEO / Founder)	Common	5,000,000
Priya (CTO / Co-Founder)	Common	3,000,000
Employees + ESOP Pool	Common (Options)	6,048,000
Redwood Ventures (Seed)	Seed Preferred	2,500,000
Apex Capital (Series A)	Series A Preferred	4,354,000
Meridian Growth Partners (B)	Series B Preferred	6,919,000
Fortis Ventures (B-2 Down)	Series B-2 Preferred	7,690,000
TOTAL		35,511,000

** Adjusted conversion prices after broad-based weighted average anti-dilution calculation. Meridian's effective price moved from $5.76 → $5.058. Apex moved from $2.80 → $2.756. Redwood was unaffected (paid below new round price).*

OWNERSHIP AFTER DOWN ROUND — SERIES B-2 (FULLY DILUTED)

You 13.8% riya 8.3 ESOP 16.7% eed 6.9 A 12.0% B 19.1% B-2 21.2%

You (CEO) Priya (CTO) ESOP Pool + Grants Redwood (Seed)

Apex (Series A) Meridian (Series B) Fortis (B-2 Down)

13.8% YOUR STAKE (WAS 18.6%)	**$12.4M** YOUR PAPER VALUE (WAS $28.8M)
$90M POST-MONEY (WAS $155M)	**$69.5M** TOTAL RAISED TO DATE

CHAPTER 05

Pay-to-Play: The Provision That Separates Loyal Investors from Tourists

Now I want to introduce a provision that is often used in down rounds and is actually very powerful for founders if structured correctly. It is called **pay-to-play.**

A pay-to-play provision says: **existing investors must participate proportionally in the down round or they lose some (or all) of their preferred stock privileges.** In other words, if you want to keep your anti-dilution rights, your board seat, your liquidation preference — you have to "pay" (invest in the down round) to "play" (keep your protections).

> FIFTH-GRADER VERSION
>
> *The pizza shop is struggling. A new person wants to buy in at a lower price. Pay-to-play says: "Old partners — if you want to keep all your special pizza privileges, you have to put in more money right now, alongside the new partner. If you do not put in money, you lose your special status. You become a regular partner with no extra benefits." It forces existing investors to either put their money where their mouth is — or step aside.*

Pay-to-play is most commonly triggered in distressed down rounds. Here is how it would work at NovaSpark.

PAY-TO-PLAY MECHANICS — NOVASPARK SERIES B-2

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Pay-to-play provision: each preferred holder must invest their pro-rata share
of the new round OR their preferred converts to common stock.

New round size: $20,000,000
Total pre-round FD shares: 26,910,000

Redwood's pro-rata share: 9.3% × $20M = $1,860,000 required
Apex's pro-rata share:   15.9% × $20M = $3,180,000 required
Meridian's pro-rata share: 22.6% × $20M = $4,520,000 required
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Scenario: Meridian declines to participate (they are deeply
underwater)
Meridian's preferred stock converts to common. They lose:
— Liquidation preference on their $35M investment
— Anti-dilution rights
— Board seat (if tied to preferred status)
Redwood and Apex participate → keep all protections
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As a founder, pay-to-play serves you well in a down round. It sorts out which investors are genuinely committed from those who are treating your company like a passive bet. An investor who will not put more money in during a hard moment but still holds all the preferred stock protections is an adversary masquerading as a supporter. Pay-to-play removes their leverage.

CFO ADVICE TO THE FOUNDER

When you are negotiating a down round, push hard for a pay-to-play provision on existing investors. Yes, some will fight it. But those who genuinely believe in the company will participate. Those who refuse are signaling that they have written off the investment anyway — and you are better off having them convert to common with no further power over your board decisions.

CHAPTER 06

The Recapitalization: When You Need to Hit Reset

Sometimes a down round is not enough. Sometimes the cap table has become so burdened — so many layers of liquidation preferences, so many preferred shares that would need to be paid out before founders or employees see a dollar — that the company cannot attract good people, cannot close an acquihire, and cannot raise a clean new round. When this happens, the board may authorize a more drastic procedure: a **recapitalization**, often called a **recap.**

A recap is a comprehensive restructuring of the cap table. It is not one clean surgery. It is a negotiation, and it is painful for everyone. The goal is to reset the capital structure so that the people who still need to create value going forward — founders, employees, new investors — have enough ownership to be properly motivated.

What Triggers a Recap

1

The Overhang Problem

NovaSpark raised $49.5M across multiple preferred rounds. Each preferred round has a liquidation preference. If the company sells for $60M, the preferred holders get paid first in order of seniority. Founders and employees may see nothing — or nearly nothing. This is called preference overhang. Acquirers know this and discount their offers accordingly. New investors will not invest because their money goes in at the bottom of a deep stack.

2

Employee Option Underwater

Employees received options at strike prices reflecting higher valuations. After a down round, those options are worth less than the strike price — they are underwater. Employees have no incentive to stay. The company loses talent at the worst possible moment.

3

Board Dysfunction

Multiple preferred classes with conflicting interests (each wanting their liquidation preference paid) can paralyze the board. Simple decisions become impossible. The company drifts.

The Recap Mechanics — NovaSpark's Scenario

NovaSpark now needs a Series C, but no serious investor will come in with $49.5M of preferred overhang sitting above them. The board agrees to a recap. The structure typically looks like this:

↺

Recapitalization Structure — Month 78

All preferred converts to common at negotiated ratios · New ESOP issued · Clean Series C structure · Board reconstituted

SIMPLIFIED RECAP STRUCTURE — NOVASPARK

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New investor (Vantage Partners) agrees to lead a $30M Series C at
$100M pre-money
Condition: all existing preferred must convert to common at negotiated
ratios.
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Negotiated conversion ratios (preferred → common):
Redwood Ventures (paid $1.00, getting 2.6× in value): 1:1
conversion
→ 2,500,000 common shares (no haircut — they are above water)
Apex Capital (paid $2.80, slightly underwater):
1:0.85 conversion
→ 3,701,000 common shares (15% haircut on share count)
Meridian (paid $5.76, deeply underwater):            1:0.50
conversion
→ 3,460,000 common shares (50% haircut on share count)
Fortis (paid $2.60, roughly at-water):
1:0.90 conversion
→ 6,921,000 common shares (10% haircut on share count)
─────────────────────────────────────────────
Post-conversion common shares (investors): 16,582,000
Founder shares (unchanged):                 8,000,000
Employee options (repriced or reissued):    4,000,000
New ESOP pool (15% post-C):                 5,000,000
New Series C shares (Vantage):              9,783,000
─────────────────────────────────────────────
Total post-recap FD shares:                43,365,000
Post-C valuation: $100M + $30M =          $130,000,000
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SHAREHOLDER	POST-RECAP SHARES
You (CEO / Founder)	5,000,000
Priya (CTO / Co-Founder)	3,000,000
Employees (Repriced Options + ESOP)	9,000,000

Redwood Ventures (converted)	2,500,000
Apex Capital (converted, 15% haircut)	3,701,000
Meridian Growth Partners (converted, 50% haircut)	3,460,000
Fortis Ventures (converted, 10% haircut)	6,921,000
Vantage Partners (Series C)	9,783,000
TOTAL	43,365,000

THE HARD TRUTH ABOUT A RECAP

No investor accepts a haircut happily. Meridian, who invested $35M, is now sitting on shares worth roughly $10.4M on paper — a 70% loss on their investment value. They will fight this. They will threaten litigation. They will demand concessions. The recap requires supermajority approval from preferred holders. That means you need Meridian to vote yes. They will extract something in return — perhaps a board seat, warrants, or a better conversion ratio. This is a negotiation, not a decree. But it is possible, and it does happen. Many of the great SaaS companies you admire today went through a painful recap at some point.

CHAPTER 07

The Full NovaSpark Journey: Six Years in One Table

Let us now see the complete picture across every round — up and down — to feel the full arc of what a founder actually experiences. This is the table that should be on your wall.

ROUND / EVENT	VALUATION (POST)	PRICE / SHARE
Founding Day	~$0	$0.001
After Seed ($2.5M)	$12,500,000	$1.00
After Series A ($12M)	$52,000,000	$2.80
After Series B ($35M)	$155,000,000	$5.76
After Down Round ($20M) ▼	$90,000,000	$2.60
After Recap + Series C ($30M) ↺	$130,000,000	$3.00 (C shares)

THE REAL TAKEAWAY FROM SIX YEARS

Your ownership went from 50% to 11.5%. Your paper value went from zero to nearly $15 million. You raised $99.5 million. You survived a down round, an anti-dilution reset, and a recapitalization. The company is still alive and growing at a

$130 million valuation. That is not a failure story. That is a founder story. The cap table is not a trophy case — it is a record of every trade you made. The only question is whether each trade was worth it. And in this case, every one of them was.

CHAPTER 08

Terms Every Founder Must Know Cold Before Signing Anything

DOWN ROUND

A funding round where new shares are priced below the previous round's price per share. Triggers anti-dilution provisions and signals a reduction in perceived company value.

ANTI-DILUTION PROVISION

A contractual right granted to preferred stockholders that adjusts their conversion price (giving them more shares) if a subsequent round is priced lower than what they paid.

BROAD-BASED WEIGHTED AVERAGE

The most common and founder-friendly anti-dilution formula. Adjusts the conversion price to a weighted midpoint between the old price and the new price, using the full diluted share count as the base.

FULL RATCHET

The most aggressive anti-dilution provision. Drops the investor's conversion price all the way to the new round's price, regardless of the size of that new round. Can be catastrophically dilutive for founders.

PAY-TO-PLAY

A provision requiring existing preferred holders to participate pro-rata in a new round or forfeit their preferred stock protections (converting to common). Forces commitment from existing investors.

LIQUIDATION PREFERENCE

The right of preferred stockholders to receive their investment back (typically 1×) before any proceeds are distributed to common stockholders in a sale or liquidation.

PREFERENCE OVERHANG

When the total liquidation preferences of all preferred classes exceed the company's likely exit value, making common stock (held by founders and employees) effectively worthless in a sale.

RECAPITALIZATION (RECAP)

A comprehensive restructuring of the cap table — typically involving conversion of all preferred to common at negotiated ratios — to clean up a preference overhang and enable a fresh start with new investors.

UNDERWATER OPTIONS

Employee stock options whose exercise (strike) price is higher than the current fair market value of the shares. They are economically worthless and cause key-employee attrition in down rounds.

PRO-RATA RIGHTS

The right of an existing investor to invest their proportional share in future rounds, maintaining their ownership percentage. Important in pay-to-play enforcement.

CONVERSION PRICE

The price at which preferred stock converts to common stock. Anti-dilution provisions work by adjusting this price downward, giving the investor more common shares per preferred share held.

DRAG-ALONG RIGHTS

The right of a majority shareholder (usually the preferred) to force all other shareholders to vote in favor of a sale. Critical in recap negotiations — the majority can drag minority holders along.

COMING IN THIS SERIES

PART 3 — ESOP DEEP DIVE

How options actually work — strike prices, 409A valuations, ISO vs. NSO, cliff and acceleration, and what your employees actually receive at exit. The math most founders never do.

PART 4 — THE EXIT WATERFALL

When the company sells for $200M — who gets what, in what order, and why. The liquidation waterfall, participating preferred, conversion decisions, and the moment of truth for founders and employees alike.

CAP TABLE MASTERCLASS · FOUR-PART SERIES

Part 2 of 4: Down Rounds, Anti-Dilution & Recapitalization

Down Round · Anti-Dilution · Full Ratchet · Weighted Average · Pay-to-Play · Recap · Preference Overhang