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## Purpose of Document

This document is written for training purposes design to let the legal professional understand how the equity Dilutions Works for Goodrose Supported Business.

## Assignment of Equity Dilution Analysis

The assignment of Learning Equity Dilutions Analysis is based on the current project. Please contact the Project Developer for getting data and accounting method before stating the assignment.

## Simple Test of Equity Dilution Analysis

In order to avoid a training fee of learning how Equity Dilution Analysis Works, all legal and financial professional who are interested in working with Goodrose Project are required to provide two samples demonstrating their writing and math abilities on how Equity Dilution Analysis Works. The samples must be presented the following format:

1. Organizational Metrics are part of this assignment
2. Excellent writing skills in Management Letters is desired to present a the Equity Dilution Analysis document.
3. APA Styles are required to complete this simple test.
4. Understand Financial Statements, the fiscal responsibilities and relations of stakeholders in the organizations, especially board and staff. Need to prepare your own simple company for the Financial Statements .
5. In this sample company, you need to create your own examples of 1) startup cash and 2) startup contributions vs. startup net assets scheduled for the 1<sup>st</sup> fiscal accounting year – Startup 1<sup>st</sup> Year Performance.
6. Your own examples of Funding Process v.s. Startup 1<sup>st</sup> Year Performance
7. Your own examples of Scaled Equities Diluted v.s. Funding Process and Performance ( 1<sup>st</sup> year, 2<sup>nd</sup> year and 3<sup>rd</sup> year)
8. Conclusion Letter. Generally this is a statement that clearly states the scaled equities based on different stages of your sample business.

## Outlines for Equity Dilutions Works in China

Equities, Cash Investment v.s. Human Capital Investment

<http://home.goodrose.com/goodrose/股东权宜与人力资本.pdf>

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Understanding Operating Partners.  
<http://home.goodrose.com/goodrose/什么是运营机构.pdf>

### Outlines for Equity Dilutions Works in United States

Don't learn about equity dilution the hard way. Understand stock dilution before you sign your employment agreement and you'll be happy you did.

Let's say, for example, that you signed up to be COO of a startup company and the CEO founder offered you 5% of the company. The CEO says there's no funding in the bank yet, so you'll have to sign up for a low salary -- \$50,000 per year.

But he assures you that he's had conversations with venture capitalists and there's a sense that if things go right, the company might one day sell for \$100 million.

Hmmm, you think. 5% -- not bad. If we sell this thing for \$100 million, I will walk away with \$5 million.

WRONG!

Your math failed to take into account stock dilution. That's the effect the issuance of new equity shares has on the existing shareholders.

Let's go back to our example and see how stock dilution works in action.

You take the job and get 5% of the company.

Odds are you don't get it all at once -- it's probably subject to a vesting schedule and it might only be stock options -- but that's not really relevant to our equity dilution lesson.

How much is 5% of your pre-funding company worth?

Not much. In fact, until there's a funding round you don't really know what it's worth.

A funding round is important to entrepreneurs and their employees because it's a milestone that values the underlying stock of the company.

So, let's say that a year after you've been working as the COO of the company, you and

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the CEO are finally able to land a funding round.

The funders says they will give you \$700,000 in capital for 35% of the company.

What exactly does that mean?

It means that the total valuation of the company after they put their money in will be equal to  $\$700,000 / .35$ , or  $\$2,000,000$ .

In VC terminology, that's the post-money valuation. The pre-money valuation is therefore  $\$1,300,000$ . That's the post-money valuation minus the value of the cash that is coming into the business as part of the funding round.

So, after the funding round, the valuation is  $\$2,000,000$  and you had 5% equity in the company, so now your equity stake is worth  $\$100,000$ , right?

WRONG!

Equity dilution knocks down your percentage stake in the business.

Here's how equity dilution works in this scenario.

Let's say there were 1,000,000 issued shares prior to the funding round. In order for the new investors to get a 35% equity stake, they need to be issued new shares.

How many shares?

It's a simple algebra problem. Let  $x$  be the number of new shares that need to be issued. The equation becomes:

$$x / (1,000,000 + x) = .35$$

Solving for  $x$  implies that 538,462 new shares must be issued to the investors.

The math says that it should be 538,461.5 but there's no such thing as half a share so we round up. Believe me, investors won't round down. If there's something on the table to be taken, they will likely grab it.

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So, now the total number of shares in the company is 1,538,462. What your percentage equity stake in the company?

Well, you were allocated 5% of the 1,000,000 shares so you had 50,000 equity shares before the funding round.

After the funding round, you still have 50,000 shares.

So, now, your diluted equity stake in the company is  $50,000/1,538,462$ , or 3.25%.

How much is it worth?

The answer is simply  $.0325 \times \$2,000,000$ . That's your percentage equity stake times the post-money valuation. As it turns out, your stake is worth \$65,000, not \$100,000 as you might have thought.

If the company were to sell for \$100 million now, after the first round of venture funding is in the bank, you 3.25% stake would be worth \$3.25 million, not the \$5 million you thought you'd get before you learned about equity dilution.

Notice that there was an easier way to figure out your post-dilution equity stake. You gave away 35% of the company in the financing round, so your 5% was knocked down by a .65 dilution factor -- that's what you got to keep, in effect. So, 5% times .65 gives you the 3.25%. It's the same answer, but it's a quick way of calculating the effect of dilution on your equity stake.

Mind you, this is just your first round of dilution. If the company has to do a second round and gives away 40% of the company to new investors, then you've got to knock your 3.25% equity stake down by a .60 dilution factor. After that second round, your ownership stake will be down to 1.95%.

Is that good or bad? It depends.

If the post-money valuation on the second financing round is \$1 billion, your stake is only worth \$19,500,000. Not bad!

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If the post-money valuation on the second round is \$2,500,000, then your equity stake is only worth \$40,950. Given the salary cut you took to get in on the action for this startup, this is a pretty miserable scenario.

Adding insult to injury is the fact that your equity stake's valuation is not real -- it's just a paper value. In a startup company there's usually no liquidity unless there's an exit event of some kind -- for example, maybe the company goes public or the company is sold to an acquiring company. At that time, you finally get to know what your stock is really worth.

What's the moral of the story?

Well, for starters, you can see that somebody who doesn't understand equity dilution is going to be overly optimistic about their likely take in a startup. They may be more willing to take a lower salary than they should be, or more willing to take a lower equity stake than they should be.

Now that you understand equity dilution, you won't make that mistake. You'll properly evaluate potential outcomes and likely funding scenarios and their dilutionary effect on your stake.

Based on your equity dilution analysis, we hope you'll make smart decisions. Good luck!

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