

Understanding your company's pre-money fully diluted capitalization: 4 items to consider

By Ian Hlatky

Pre-money value has the single biggest impact on determining the percentage of a company an investor is going to acquire for a given investment (and, as a result, what percentage of the company the existing stockholders will retain).

However, valuation is only half of the story. The other half of the story is what comprises the "pre-money fully diluted capitalization."

How does the pre-money fully diluted capitalization impact financing numbers?

After the pre-money valuation, what gets counted as part a company's pre-money fully-diluted capitalization has the biggest impact on relative ownership stakes in a company after a financing.

The formula used to derive the price per share (PPS) than an investor will pay for a company's stock is the following:

$$\text{PPS} = \text{pre-money value} / \text{fully diluted capitalization}$$

Generally, the pre-money value is constant. PPS and fully diluted capitalization are indirectly proportional (*i.e.*, as one goes up, the other goes down), so the larger the fully diluted capitalization, the smaller the amount an investor will pay per share (and, thus, the more shares the investor will receive for a given investment and the larger the portion of the company it will own after the financing). This is why fully diluted capitalization is an important determinant of ownership interests in a company after a financing.

Wait a second, isn't a company's fully diluted capitalization set in stone?

No. Although it is pretty much universal that any and all stock that has been issued prior to the financing is included in a company's fully diluted capitalization, there are variations around other items that may be included as part of the fully diluted capitalization. Because counting or not counting these items will impact the fully diluted capitalization and, as a result, the relative ownership interests after the financing, the parties to a financing should understand and carefully consider the following four items when negotiating term sheets.

I. Treatment of options and warrants

In nearly all cases, investors will require that a company's fully diluted capitalization include any and all options and warrants that are outstanding prior to the investment. The argument for such inclusion is that, although the holder of such options or warrants may never actually exercise such options or warrants (eg, if the holder ceases to perform services for the company and the options or warrants terminate), the company is likely to grant a similar number of options or warrants to the parties who would replace those former service providers.

Example: BigVC is going to invest \$2 million into GiantCo based on an \$8 million pre-money valuation. The term sheet dictates that the fully diluted capitalization include all outstanding stock plus granted options and warrants. GiantCo's fully diluted capitalization is as follows:

Stock	6,000,000 shares
Options	1,800,000 shares
<u>Warrants</u>	<u>200,000 shares</u>
Total	8,000,000 shares

Here, the price per share that BigVC would pay for its stock would be: \$8 million (pre-money valuation) / 8 million shares (fully diluted capitalization) = \$1. Accordingly, BigVC's \$2 million investment would buy it 2 million shares.

2. Treatment of shares reserved in an employee option plan

More often than not, investors will also require that a company's fully diluted capitalization include any shares that have been set aside in an employee option plan even if yet granted at the time of an investment. The argument for such inclusion is based on assumptions that (i) the company will grant options for all such set-aside shares in the future and (ii) the holders of such options will exercise their options for stock.

Example: BigVC is going to invest \$2 million into GiantCo based on an \$8 million pre-money valuation. The investment term sheet dictates that the fully diluted capitalization include all outstanding stock, all granted options and warrants and any shares reserved but unissued under an employee incentive plan. GiantCo's fully diluted capitalization is as follows:

Stock	6,000,000 shares
Options	1,800,000 shares
Warrants	200,000 shares
<u>Plan shares</u>	<u>1,000,000 shares</u>
Total	9,000,000 shares

Here, the price per share that BigVC would pay for its stock would be: \$8 million (pre-money valuation) / 9 million shares (fully diluted capitalization) = \$0.8889. Accordingly, BigVC's \$2 million investment would buy it 2.25 million shares. For more about sizing the option pool, [please see our article](#).

3. Increase in employee option pool (and treatment thereof)

It is fairly commonplace in venture investments that investors will require that (i) a company increase the total number of shares that it has set aside in an employee option plan and (ii) that the company's fully diluted capitalization include all such shares set aside. The argument for this is based on assumptions that (i) the company will need to grant service providers more options than it currently has available in its employee option pool (often as a result of new hires made with the new money that the investor is investing), and (ii) such holders will exercise those options for stock.

Example: BigVC is going to invest \$2 million into GiantCo based on an \$8 million pre-money valuation. The term sheet dictates that the fully diluted capitalization include all outstanding stock, granted options and warrants, any shares reserved under an Employee Incentive Plan and an increase in the shares reserved under an employee incentive plan. GiantCo's fully diluted capitalization is as follows:

Stock	6,000,000 shares
Options	1,800,000 shares
Warrants	200,000 shares
Plan shares (current)	1,000,000 shares
<u>Plan shares (increase)</u>	<u>1,000,000 shares</u>
Total	10,000,000 shares

Here, the price per share that BigVC would pay for its stock would be: \$8 million (pre-money valuation) / 10 million shares (fully diluted capitalization) = \$0.80. Accordingly, BigVC's \$2 million investment would buy it 2.5 million shares. For a discussion of some of the consideration in increasing the option pool, please see our article on [sizing the pool](#).

4. Treatment of convertible securities

Occasionally investors will also require that a company's fully diluted capitalization include any shares of stock that are being issued in the financing on account of convertible notes or SAFEs that are converting in connection with a financing. The argument for such inclusion is that (i) the company already received the money for such convertible notes or SAFEs and (ii) because no new money is being received, any shares issued in consideration for the conversion of such securities should be counted as if they were outstanding prior to the new investment (ie, rather than treating such shares as if issued for new cash able to be leveraged by the company).

Example: BigVC is going to invest \$2 million into GiantCo based on an \$8 million pre-money valuation. The investment term sheet dictates that the fully diluted capitalization include all outstanding stock, all granted options and warrants, any shares currently reserved under an employee option plan, an increase in the shares reserved under an employee option plan and all shares issued in consideration for Convertible Notes and SAFEs. GiantCo's fully diluted capitalization is as follows:

Stock	6,000,000 shares
Options	1,800,000 shares
Warrants	200,000 shares
Plan shares (current)	1,000,000 shares
Plan shares (increase)	1,000,000 shares
<u>Note & SAFE shares</u>	<u>1,000,000 shares</u>
Total	11,000,000 shares

Here, the price per share that BigVC would pay for its stock would be: \$8 million (pre-money valuation) / 11,000,000 shares (fully diluted capitalization) = \$0.7273. Accordingly, BigVC's \$2 million investment here would buy it 2.75 million shares. For a more detailed discussion of convertible notes and SAFEs, [please see our article](#).

Takeaway

After valuation, what comprises a company's fully diluted capitalization has the biggest impact on who will own how much of a company after a financing. Using the above examples, a given \$2 million investment into a company that has 6 million shares outstanding based on an \$8 million pre-money value can result in the investor receiving anywhere from 2 million shares to



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2.75 million shares, depending upon what gets included in the fully diluted capitalization. What actually gets included as part of the fully diluted capitalization is not set in stone. It is critical to agree on the nature of the fully diluted capitalization to avoid inadvertently giving away more of the cap table than intended.

You may also be interested in [our article about pre-money value](#).

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