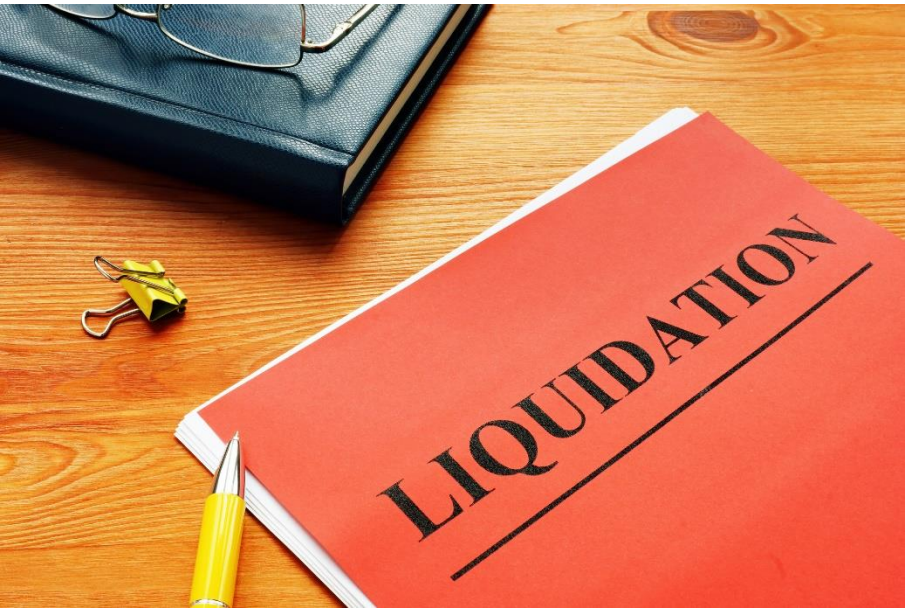
Liquidation Preferences and Participating Preferred Stock: How VC Terms Affect Deals

And How Venture Capitalists Always Protect Themselves First…



This Lesson: VC Deals 101

You can find many explanations online about *common terms* in venture capital investments, such as **liquidation preferences**.

But in this tutorial, we'll explain how these terms are relevant in *investment banking* and corporate finance roles.

This Lesson: VC Deals 101

So: This will be a *quick introduction / summary* of a very broad topic (entire books are written about it).

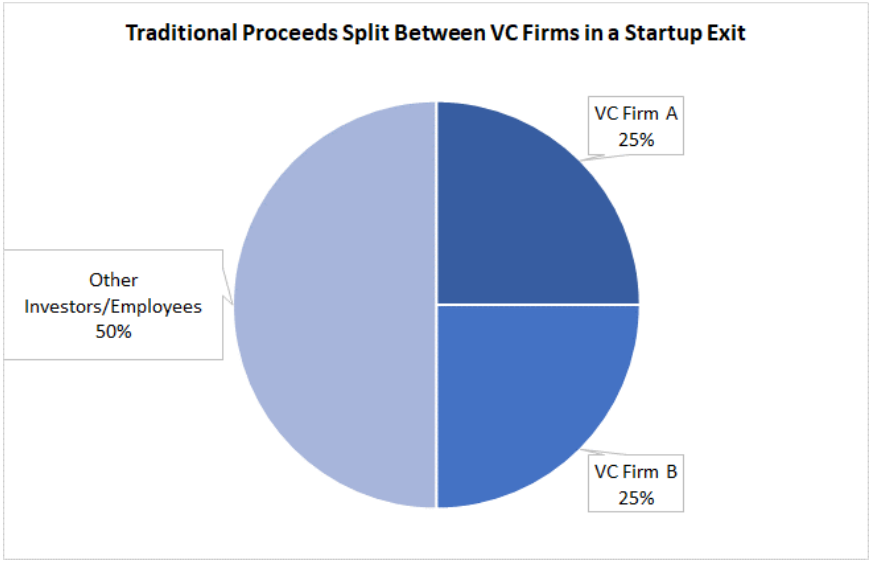
Plan: I will go through a simple Excel example with two VC firms investing in a startup and then explain how VC-specific deal terms might *change their outcomes*.

The Short Answer About VC Terms

- **Simple Example:** Let's say that VC Firm A and VC Firm B each own **25%** of a startup

- **Startup Exit:** The startup gets a $100 million acquisition offer

- **So:** If the startup accepts the offer, VC Firm A gets $25 million, and VC Firm B gets $25 million, right?



The Short Answer About VC Terms

- **Nope!** The *distribution of proceeds* won't necessarily match the VC firms' *ownership on paper*

- **Why:** When VC firms invest in startups, they almost always do so by purchasing **preferred stock**, not common stock, which comes with **additional rights, privileges, and terms**

- **So:** If they want, they can convert their preferred shares into common shares – this is the norm in IPOs or large exits

- **But:** If they could earn more by keeping their preferred shares, they will do that instead!

The Short Answer About VC Terms

- **So:** In a $100 million exit, you could easily have a case where VC Firm A gets $25 million, but VC Firm B gets **$40 million**:

- **Or:** Virtually any other split is possible

- **Main Factors:** The $ amounts the VCs invested, the valuations at which they invested, and the **liquidation preferences** and **participating preferred terms** attached

The Short Answer About VC Terms

- **In Investment Banking:** These terms matter if you're advising **startups** and private companies because they affect the appeal of various **exit options**

- **Example:** Company management may not want to accept a sub-par acquisition offer because it means less in proceeds for them

- **But:** The VC investors might want to exit ASAP so they can earn some money back and focus on higher-performing companies

- **Standard Public Companies:** These points don't come up because all the common shareholders are treated the same way, and senior investors get paid first based on simple rules

Venture Capital Deals: Lesson Overview

- **Part 1:** Company Ownership in Series A and B Rounds **5:25**
- **Part 2:** Liquidation Preferences Concept & Calculations **8:51**
- **Part 3:** Participating Preferred Concept & Calculations **15:57**

Company Ownership Calculations

- **This Example:** Extremely simplified to illustrate the basic concepts – skipping employee option pools, stock grants, etc.

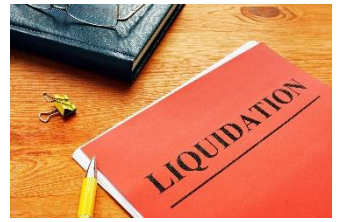
- **"Series A" Round:** The first significant outside investment in a startup, which usually helps it attain product/market fit

- **"Series B" Round:** The second outside investment, which usually helps the startup scale and sell/market more effectively

- **Main Point:** # Common Shares After Each Round = Previous Common Shares / (1 – New Ownership Created or Granted)

Liquidation Preference Concept

- **Liquidation Preference:** If a VC investor chooses to keep its preferred stock, it receives a **fixed dollar amount** when there's a "liquidation event" (sale, bankruptcy, etc.), up to the amount the exit proceeds can cover



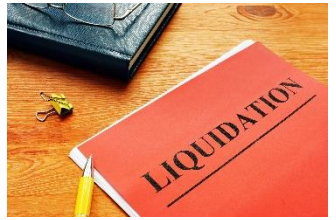
- **This Amount:** Almost always a multiple of the initial investment from the VC, such as 1x, 2x, 3x, etc. (1x is the most common)

- **And:** If the exit proceeds cannot pay for each VC's Liquidation Preference, it goes in order of "seniority" (variations exist)

- **PURPOSE:** Protect VCs from investing in a company at a $100 million valuation, and the company then selling for $80 million

Liquidation Preference Calculations

- **Simplest:** If there are few investors (VC Firms A and B) and *only* Liquidation Preferences, with no other special terms:



- **Step 1:** Calculate each VC Firm's exit proceeds if they were to convert into common stock

- **Step 2:** Pay out the **greater** of these common stock proceeds or the Liq. Pref. to each VC, up to the total proceeds available

- **Step 3:** Everything left after these payouts goes to the **common shareholders** (Founders, management, employees, etc.)

Participating Preferred Concept

- **Participating Preferred:** If a VC firm keeps its preferred stock, this term lets the firm get its Liquidation Preference *and* also "participate" as a common equity investor by taking a percentage of the proceeds remaining after that!

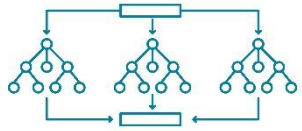
- **Double Dip:** It allows VC firms to get "the best of both worlds" by recovering their initial investment and getting *more* on top

- **And:** It *heavily* skews the exit proceeds in favor of the VCs

- **So:** If this term exists, there is usually a **Participation Cap**, such as 2x or 3x, that limits the VC's total proceeds to a multiple of their Liquidation Preference (*not* the initial investment)

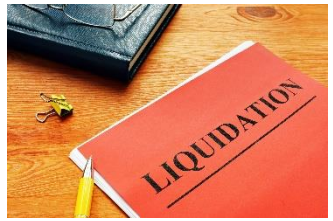
Participating Preferred Calculations

- **Decisions:** It's more complicated, and you have to plot out the conversion options to determine the optimal set of decisions



- **Step 1:** Calculate each VC Firm's exit proceeds if they convert to common stock; fill in the Participation Cap and other terms

- **Step 2:** Calculate and deduct all **Liquidation Preferences** from the Exit Proceeds based on the conversion decisions



- **Step 3:** Calculate and deduct the **Participating Preferred Proceeds** based on the conversion decisions and Participation Caps

Participating Preferred Calculations

- **Step 4:** Re-calculate the common shares and ownership after these distributions, based on which investors have converted

- **Step 5:** Distribute the remaining proceeds to the common equity investors based on their ownership percentages at this stage

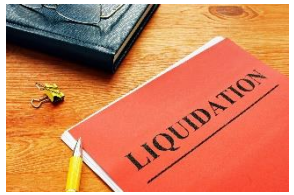
- **Real Life:** Set up a more complicated Excel model that plots the different possibilities; “optimal” decisions are the ones that **minimize the proceeds to the common shareholders**

- **Also:** If the terms are messy enough, an IPO, in which all preferred stock tends to convert to common, is often best

Recap and Summary

- **Part 1:** Company Ownership in Series A and B Rounds

- **Part 2:** Liquidation Preferences Concept & Calculations



- **Part 3:** Participating Preferred Concept & Calculations