Navigating the dead zone

Understanding liquidation preferences in venture capital

In the second of a series of blogs aimed at demystifying common provisions found in venture capital term sheets (with the hope of accelerating the negotiation process between investors and founders), Peter Sugden looks at liquidation preferences.

What is a liquidation preference?

A liquidation preference is a right which:

- attaches to the class of shares issued to an investor (usually known as "preference shares")
- applies where there are funds to be distributed to shareholders on a liquidation event, and
- allows the investor to receive a share of those funds before any other shareholder.

In short, it enables the investor to recover the amount it has invested (or sometimes more than the amount it has invested) in priority to any other shareholder. It is often referred to as "downside protection" on the grounds that it protects the investor in the event a company performs poorly by seeking to ensure that the investor gets its money back first.

When does it apply?

A liquidation preference is a partial misnomer – its reach is broader than its name implies. It applies on classic liquidation events (ie a liquidation or solvent winding-up of the company where the company ceases to trade and its assets are distributed to shareholders); however, importantly it also applies on a "deemed liquidation", which typically includes a sale of shares by shareholders in the company or a sale of all or a substantial part of the assets of the company. Whenever funds become available for distribution amongst shareholders, the liquidation preference applies. Therefore, a liquidation preference amounts to an agreement between shareholders on how proceeds are distributed in both worst case scenarios (an insolvent liquidation) and best case scenarios (exit by way of sale).

It should be noted, as an aside, that there is sometimes a debate as to whether an IPO of a company should constitute a "deemed liquidation" and trigger the liquidation preference. In my view, it should not for the simple reason that an IPO constitutes an additional fundraise by the company (it is issuing or selling shares for cash) and is not an event which naturally results in proceeds being available for distribution.

Why do investors want it?

Equity investment comes, inevitably, with a significant element of risk. Investors want equity because it can have huge upside – if the company is a success, having equity allows an investor to participate in that success (ie take the "upside"). But investors also like debt because debt holders receive money before shareholders if the company is wound up (ie protect against the "downside"). Therefore, the liquidation preference has evolved to give investors some of the benefits of a debt investment, while retaining the benefits of an equity investment. It allows investors to participate in the upside, while being (better) protected than other shareholders against the downside.

That is not to say that the liquidation preference should be seen as an unfair term imposed on defenceless founders though. Firstly, it should be noted that a liquidation preference is by no means a panacea for risk on an investor's equity investment. In an insolvency scenario, there are often no proceeds whatsoever to distribute to shareholders. As a shareholder (albeit a preferred shareholder) the investor will still sit behind debtholders when a company is wound up. A liquidation preference in that scenario gives an investor a priority,

but it is a priority over nothing. Secondly, venture capital investors will often justify the liquidation preference on the grounds that they are making significant investments in companies which are, on the whole, still controlled by the founders. The liquidation preference is therefore often seen as a necessary corollary of a company gaining access to the funds of a venture capital investor.

So what exactly are the financial terms that apply to liquidation preferences?

There are two key elements to the liquidation preference: (i) the amount of the initial preference and (ii) whether the investor's shares continue to participate in distributions of proceeds after the initial preference has been paid.

As set out above, the liquidation preference is designed to give the investor the ability to recover the amount it has invested (or a multiple of that amount) before any other shareholder on a liquidation event. So, if an investor has invested £1m with a 1x liquidation preference, the first £1m of any proceeds payable on a liquidation event will be for that investor (if it has a 2x liquidation preference, the first £2m will be for that investor, and so on). These are the amounts that the investor gets before any other shareholder and represents the initial preference element of the liquidation preference.

The second element is how the investor participates in amounts to be distributed to shareholders in excess of the initial preference. So, in the example above, if an investor has invested £1m with a 1x liquidation preference, and the proceeds available for distribution to shareholders on a liquidation event are £10m, then the first £1m of those proceeds are for the investor, but how are the remaining £9m of proceeds shared?

This depends on whether the liquidation preference is "participating" or "non-participating".

A liquidation preference which is non-participating only entitles the investor to recover its initial preference. Once it has received that preference, the remaining proceeds will be shared between the rest of the shareholders. Accordingly, in the example above, the investor receives £1m and the other shareholders receive £9m to share between them.

On the other hand, a liquidation preference which is participating will entitle the investor to recover its initial preference (in priority to the other shareholders) and then to participate in the residual proceeds for distribution alongside the other shareholders on a pro rata basis according to the percentage of shares it holds in the company. That is why the participating preference is sometimes referred to as a "double dip".

How does that work in practice?

Clearly, a participating preference is more favourable to the investor and a non-participating preference is more favourable to the founder. However, just how stark this may be can be shown using an example with different proceeds for distribution.

Imagine a venture capital fund invests £5m in a company in return for 20% of the fully diluted equity and the company is then sold a few years later. Table 1 sets out how much of the sale proceeds the venture capital fund will receive at different sale values on a 1x liquidation preference. Where the interest is a non-participating preference, the venture capital fund only receives the value of the initial preference of £5m. Where the interest is a participating interest, the venture capital fund receives both the value of the initial preference of £5m and the value of the participation, being 20% of the sale value above £5m.

Sale value (proceeds for distribution to shareholders)	Where there is a 1x non-participating preference		Where there is a 1x participating preference		
	Initial preference	Initial preference as a percentage of sale value	Participation: 20% share of sale value above £5m	Total share of consideration (Initial preference + Participation)	Total share of consideration as a percentage of sale value
£5m	£5m	100%	£0	£5m	100%
£10m	£5m	50%	£1m	£6m	60%
£15m	£5m	33.3%	£2m	£7m	46.6%
£20m	£5m	25%	£3m	£8m	40%
£25m	£5m	20%	£4m	£9m	36%
£30m	£5m	16.6%	£5m	£10m	33.3%
£40m	£5m	12.5%	£7m	£12m	30%
£100m	£5m	5%	£19m	£24m	24%
£200m	£5m	2.5%	£39m	£44m	22%
£500m	£5m	1%	£99m	£104	20.8%

Table 1

As can be seen from Table 1, a participating preference has a significant impact on the distribution of proceeds where the company has performed poorly or enjoyed moderate success. However, the impact of the participating preference significantly weakens as the sale value increases. On a £500m sale, the participating preference gives the investor only a 0.8% uplift against its equity stake of 20%, whereas on a £10m sale the investor takes a 40% uplift.

Deepak Malhotra makes a very perceptive observation on this point in the Harvard Business Review. Mr Malhotra's view is that an investor who insists on a strong liquidation preference (eg a participating preference) may believe that the valuation proposed by the founders is too high (ie that the investor is receiving too small a percentage of the equity for the investment it is being asked to make). Accordingly, Malhotra says that: "If a founder receives a high valuation in exchange for a high liquidation preference, the liquidation preference constitutes a side bet between the [investor] and the founder regarding whose expectations are more accurate". That is to say, if the company goes on to be very successful, the impact of the liquidation preference is much reduced and the founder's optimistic view on valuation will have been justified. However, if the company is not a success, then the investor has the benefit of a strong liquidation preference to give it a higher share of the proceeds for distribution than it would otherwise have received – and its view on the company's (over-)valuation will have been correct.

Why would an investor take a non-participating preference?

Whenever an investor agrees to take a non-participating preference, it will require the right to convert its preference shares into ordinary shares (ie the same shares as the founders) prior to the liquidation event. The rationale for this can be seen from Table 2.

Sale value (proceeds for distribution to shareholders)	Where there is a 1x non-participating preference		Where the investor converts into ordinary shares	
	Initial preference	Initial preference as a percentage of sale value	Pro rata share (20%) of sale value	Total share of consideration as a percentage of sale value
£5m	£5m	100%	£1m	20%
£10m	£5m	50%	£2m	20%
£15m	£5m	33.3%	£3m	20%
£20m	£5m	25%	£4m	20%
£25m	£5m	20%	£5m	20%
£30m	£5m	16.6%	£6m	20%
£40m	£5m	12.5%	£8m	20%
£100m	£5m	5%	£20m	20%
£200m	£5m	2.5%	£40m	20%
£500m	£5m	1%	£100m	20%

Table 2

A non-participating preference protects an investor against downside where the company has performed poorly (for example, all exits below £25m in Table 2). However, in the absence of a right to convert into ordinary shares, it would also prevent the investor from benefiting from the upside where the company has performed well (all exits above £25m in Table 2). An investor will therefore convert into ordinary shares (and forego its right to a non-participating liquidation preference) where, economically, it is better for the investor to do so. As can be seen from Table 2, that would be on any exit generating proceeds in excess of £25m.

It is important to note that the use of non-participating preference shares can create a misalignment of interest between founders and investors. In the example above, the investor knows that it will get its £5m back, but no more than £5m, on any exit between £5m and £25m. In contrast, the other shareholders will only start receiving proceeds on amounts above £5m and will receive an ever-increasing amount of proceeds the higher the valuation. Accordingly, the other shareholders are very incentivised to achieve a high valuation, but the investor is indifferent to the valuation on any amount between £5m and £25m (because it will not change the investor's economic return: it is either worse off or no better off by converting into ordinary shares). This spread of valuation in which interests can be misaligned is called the "dead zone" and it is key for founders to bear this in mind when considering potential exit valuations and the impact of those valuations on their own returns.

RPC

What does it mean for a start-up?

Liquidation preferences are a very common part of venture capital investment (albeit less common in early stage investment rounds for tax reasons). In the current market, it is common for investors to expect a 1x non-participating preference with a right of conversion into ordinary shares. It is less common to see participating preferences or non-participating preferences with a higher multiple (eg 2x or 3x non-participating preferences), but as ever these depend on the particular bargaining power of the company and the investor in a given scenario.

From an investor's perspective, it is key to bear in mind that extracting very investor-friendly liquidation terms can be a Pyrrhic victory for two reasons. Firstly, if the liquidation preference is very strong, then it may serve to demotivate founders and employees. If the ordinary shares only participate where the company achieves an unrealistically high exit valuation, then founders/employees may not feel like they have sufficient economic incentive to drive the business forward. Secondly, if the company requires further funding going forward, then any new investor will likely require at least equivalent liquidation rights to the original investor and will expect their liquidation rights to rank in priority to the original investor's. Accordingly, the original investor may see itself being pushed down the distribution waterfall.

From a founder's perspective, it is vital to understand the effect of a liquidation preference on the founder's equity. A liquidation preference (or various layers of liquidation preferences where several rounds of venture capital funding have been obtained) can, in an extreme scenario, render the founder's shares of little or no value in an exit scenario. For example, it has been reported that when the fantasy sports provider Fan Duel was sold in 2018, the founders did not receive any proceeds whatsoever due to the cumulative effect of liquidation preferences across several funding rounds – notwithstanding that the company had been valued at around £465m. Founders should remember that the price for receiving a high valuation from an investor may sometimes be a draconian liquidation preference. A high valuation may look good on paper, but founders should ask themselves: what does it translate into in terms of proceeds for the founders once the liquidation preference has been paid?

Any comments or queries?

Peter Sugden
Partner
+44 20 3060 6317
peter.sugden@rpc.co.uk

Tower Bridge House
St Katharine's Way
London E1W 1AA
T +44 20 3060 6000

Temple Circus
Temple Way
Bristol BS1 6LW
T +44 20 3060 6000

38/F One Taikoo Place
979 King's Road
Quarry Bay, Hong Kong
T +852 2216 7000

12 Marina Boulevard
38/F MBFC Tower 3
Singapore 018982
T +65 6422 3000

RPC