In this section, we're going to talk about liquidation preferences. One should always remember to stay well hydrated when discussing liquidation preferences.

Clint: What's a liquidation preference and why should I care?

Brad: In a venture deal, the investor is going to put money into your company using a type of instrument typically called a preferred stock or preferred investment. That preferred stock will be different than the stock that the founders have, which is typically common stock.

There are a number of different features of the preferred stock, many of which we'll go through. The biggest and most visible is this notion of liquidation preference.

The power of liquidation preference, in the context of the economics of a transaction, is that it means that the investor gets the choice of getting their money out first or getting their ownership.

Let's go back to that investment we were talking about earlier; the $2 million investment on a $3 million–pre/$5 million–post. You'll notice that I, being the good investor that I am, negotiated the lower valuation and used the $5 million number as the post money value versus the pre.

We, the investor, own 40% of the company. We have a liquidation preference of $2 million. That means we get a choice of either the $2 million or the 40% of the company in a transaction.

Let's say you sold the company for $10 million. In that case, I'd have the choice of 40% of the company, or $4 million, or $2 million, which is my liquidation preference. Which would I take?

Student: Four.

Brad: Four. I would take the 40% of the company.

Now, let's say instead that the company gets sold for $2 million. It didn't really work out, but we still got a $2 million deal done. I know have a $2 million liquidation preference or I can take 40% of the $2 million dollars, which in that case is $800,000.

What do I get that time?

Student: Two.

Brad: Two. So in the case where we sell the company for $2 million, the investor gets $2 million and the entrepreneurs get zero. In the case where we sell the company for $10 million, the investor gets $4 million and the entrepreneur gets $6 million.

The liquidation preference is a way where the investor protects his money and gives himself a way to get back his money first in a downside case.

Clint: You described the case of a one X liquidation preference, as they sometimes call it. You get the same amount of money back as you put in. Do you see a circumstance where it's different than one X?

Brad: There are two types of liquidation preferences. The type I just described to you was the simple liquidation preference, also called non-participating.

There's another type of liquidation preference, which is called a participating preferred or sometimes people refer to it as participation. The notion there is that the investor, in a case where there's participating preferred, gets their liquidation preference, or gets their investment back, and then they convert into common stock and get their ownership in common stock.

In the downside case that I gave, it didn't really matter because the investor got all the money anyway. However, it makes a big difference in that upside case.

So even in the case where the company got sold for $10 million, a participating preferred would mean that the investor would get back their $2 million first and then they'd get 40% of what's left.

What's left is $8 million, so they get $3.2 million. In that case, they'd the $3.2 million for their 40% plus the $2 million for their participating preferred.

As a result, the investor, instead of getting the $4 million they got for the 40% of the company in the last case, would now get $5.2 million. The entrepreneurs, instead of getting $6 million, would now get $4.8 million.

That's a participating preferred. I'm working with relatively small numbers and you may say, "I'm not sure I care that much if a company is worth $100 million." Let's say that's the only round of investment you ever take and that we sell the company several years later for $100 million.

In that case, the investor gets their $2 million first, now there's $98 million left, and then they get 40% of the $98 million. Really, they got a little bit more than they would have gotten if they just got $40 million instead, for their 40% of the $100 million. Now they get $42 million or so. Not that big a deal.

However, participating preferred and preferences tend to roll all the way through. So each time you raise an additional financing, if you have a preference in your financing structure early on, the later stage investors will often get that participation as well.

As a result, as you raise incrementally more money, the amount of that participating goes up. Let's say you'd had to raise a few more rounds and you raised a total of $25 million and you ended up selling to get $25 million, 60% of the company instead of 40%.

You did a nice up-round for your next financing. In the case of a participation, that $25 million would come off the top and there'd only be $75 million for the investors and the entrepreneurs to split 60/40. If there was no participation, the whole $100 million would be being split 60/40.

Participating preferred has a big impact on the economics of the company.

Clint: Questions…

Student: Yes. Brad, does participation ever stop?

Brad: There is this concept of a capped participation or a cap on the participating preferred. Often times in financings you'll see a participating preferred with a two-X or a three-X or a four-X cap.

What that means is that the investor participates until they get a three-X return. Once they get a three-X return, they don't participate.

The interesting thing that happens there is that there's often a flat spot in the return curve, where the investor basically has this choice of taking the three-X return or the ownership he has in the company. It takes a while for the ownership to catch up to where that's worth more than the three-X return.

You might find yourself in a position as an entrepreneur where your investor who has a cap doesn't care whether you sell the company for $100 million, $125 million, or $150 million because they make the same three X in any scenario.

Now, if you have a participating preferred, having a cap is always better than not having a cap. However, the best case is to not having a participating preferred at all.

Student: So do firms tend to always participate or never participate, or is it very circumstantial? Also, if they want to participate, does that say something about what they think about the deal?

Brad: It's changed a lot over time, partly I think because entrepreneurs understand this better now.

It used to be the case back in the 80s when I was young and involved in this stuff as an entrepreneur, you often saw participating preferred, especially on the East coast. West coast investors liked to talk about how they never did stuff like that, but they did, too.

You really saw it as prominent feature in many investments in the 80s and the early 90s. It went away and you started seeing it again after the internet bubble, as companies raised money but were really struggling and investors, when they put money into an investment at a higher price or a new term, wanted to make sure they had a guaranteed return.

That went out of fashion again 2007, 2008, 2009. You tend to see it only in situations with either high valuations or from particular firms that are trying to grab incremental economics in the transaction.

It turns out that if an early-stage investor sits down and models it out, there's a pretty compelling argument about never having a participate as an early-stage investor, if you assume that later-stage investors will get the participate as well.

However, some investors just don't get it and as a result they want a participating preference because they think it's better for them.

There is no right answer to whether it's firm specific or market specific or timing specific. It varies with the actual investment. There are firms like Foundry Group that almost never do participating preferred. We just don't like them. We'd rather keep the deal simple. We'd rather keep alignment with the entrepreneur.

That doesn't mean we'll never allow one of the companies where an investor haven't participated in a deal, sometimes that's what it takes to get there. It varies a lot.

Student: What defines liquidation?

Brad: A liquidation event is often defined clearly in your documents that part of the deal that gets put together with the term sheets that turns into the actual financing documents.

Those characteristics are: a sale of the company; a sale of a majority of the company, sometimes. The, effectively, equivalent of change of control, but not always. You might sell a majority of the company in a financing, in which case it's not a liquidation event.

A situation where the company goes public, while not a liquidation event or a liquidity event, often is a situation where the preferred stock and all of this stuff we're talking about converts into common.

There are different things that can trigger what is effectively a liquidity event and it's important for the entrepreneur to understand that and be aligned with the investors going in.

Student: How often do we see a one-X liquidation preference versus a two-X or a three-X or even a five?

Brad: One of the things I've always found particularly difficult to explain is the notion of a one-X preference. For a lot of people, a one-X preference means that there's no participation.

So I tend to try to separate the concepts and say there's a liquidation preference, which means you get your money back or you get the percent ownership, that's case A. Case B is that you have participation. The participation can be one time, so you get your money back one time and then you flip into common.

Then there's a third construct, which is the cap, which is how many multiples do you get participation for or only have the choice of getting your percent ownership.

If you take those three separate concepts, every now and then you'll see a participate that's more than one X. You'll see someone who asks for a two-X preference. That's not a two-X cap. That means they get two X their money back and then get their percent ownership. You don't see that very often. That's pretty rare, pretty infrequent, but it does sneak in.

The bigger problem is, as this session has probably generated, a lot of confusion around these terms. It's one of the reasons why, as an entrepreneur, it's important to understand the participation and the preference dynamic in the deal and how it affects who gets what in actual exit.

A lot of entrepreneurs would focus, like we talked about, on higher price, "I want to get a better price." However, that higher price with the participate might be a worst deal than a lower price with no participate, just based on these characteristics.

Really understanding the math of how that's going to play out over time is important.