IT'S TIME TO DO AWAY WITH PARTICIPATING PREFERRED

The collapse of the Internet/Telecom Bubble led to a radical change in venture capital deal structures. The deals being done in the post-bubble period were mostly follow-on financings and were often down rounds. The term sheets for these rounds contained various risk-reducing features, including multiple liquidation preferences, senior liquidation preferences, stronger anti-dilution protection, pay-to-play provisions, and participation features. As many operational performance issues in portfolio companies began to be resolved, most of those risk-reducing mechanisms were seen to be counterproductive—an attempt to “close the barn door after the horse was gone.” Many industry participants came to see these onerous terms as a shortsighted reaction to the market downturn.1 Most VCs have been less inclined to include them in today’s deal structures. However, there is one exception—the continued widespread use of participation.

Market data proves this point. According to a continuing survey of deal terms in the San Francisco Bay Area conducted by the law firm Fenwick & West, participation was used in 73% of financings in the third quarter of 2002. This percentage has remained high (65%) in the first quarter of 2006. In contrast, 32% of senior liquidation preferences had multiple preferences in the same period in 2002 vs. 14% in early 2006. Likewise, 15% of financings in Q3 2002 had full ratchet anti-dilution protection, but only 4% of deals had this feature in Q1 2006.

Participating preferred should go the way of the other risk-shifting terms that, now that the smoke has cleared, are seen as little needed. In today’s world, participation can be a negative signal to the marketplace about the investor’s confidence in the company. It can also encourage future investors in later rounds of the same company to include it in their term sheets, thereby changing the risk/return equation for the early investors.

Old conventional wisdom: convertible preferred

In the late 1990s, the standard security in venture deals was convertible preferred stock with a single liquidation preference. This security became popular because it aligned the interests of the VCs with those of the entrepreneurs, who typically held common stock.

Convertible preferred stock with a 1X liquidation preference provided downside protection for the VC by ensuring that he would receive a return of his original investment if the company were sold for a valuation lower than the valuation at which he had invested. This removed any

Figure 1 — Convertible Preferred

Notes to figures:

* $I_0 =$ initial investment amount.
* $V_0 =$ post-money valuation (after investment $I_0$).

Percentage ownership obtained by investment. $I_0 = I_0/V_0$

Breakeven enterprise value at which $V_{CP} = V_{PP}$

For $V_E > V_{BE}$, $V_{CP} > V_{PP}$

For $V_E = V_{BE}$, $V_{CP} < V_{PP}$
temptation for the management team to sell the company at a valuation that was attractive to them but left the VC with a loss.

On the upside, if the company performed well, the convertible preferred stock would, as the name indicates, be converted to common stock and the VC would participate in increases in value on a pro rata basis with the common shareholders (according to the number of common shares held by each).

Figure 1 shows how convertible preferred works for a company financed with only one issue of convertible preferred stock. The figure shows the value of the convertible preferred on the Y axis as a function of the enterprise liquidation value on the X axis.

For any enterprise liquidation value above the post-money valuation $V_0$, the investor would convert to common stock upon liquidation and would participate in the company’s exit value in direct proportion to his share of the common stock (region A on the figure). $I_0/V_0$ represents the share of ownership that the VC gets for his investment $I_0$.

For liquidation values from $V_0$ down to $I_0$ (region B), the investor will exercise his liquidation preference and receive just his original investment $I_0$. If the liquidation value is below $I_0$, the investor will receive the liquidation value (region C) and the common shareholders would receive nothing.

**New conventional wisdom: participation**

Many VCs reacted to the decline in value of many of their portfolio companies in the post-bubble downturn by determining that the value protection of straight convertible preferred was insufficient. They wanted some return on their investment even if the company was liquidated at a value that was less than the valuation at which they had made their investment. Just receiving a return of the original investment in such circumstances was considered not good enough. As a result, the “participation” feature became more customary in term sheets. Entrepreneurs with few financing alternatives had little negotiating leverage to avoid this feature. Also, at first blush, participation did not sound all that radically different. Like convertible preferred, there were liquidation preferences combined with common shares.

However, for knowledgeable investors or entrepreneurs who analyzed financing structures carefully, participation was sometimes described as “having your cake and eating it too.” In contrast to convertible preferred stock (where the investor receives either common stock or his initial investment back), with participating preferred the investor receives both common stock and his initial investment. Participation, in effect, requires that the entrepreneur transfer to the investor a share of the enterprise value built up by the entrepreneur prior to the investment. That value transfer is equal to the enterprise value multiplied by the new share of ownership of the investor also participates in any remaining value in direct proportion to his shareholdings. Participating preferred can be considered a combination of redeemable preferred stock and common stock.

Thus, the investor receives his liquidation preference and participates in any value above his liquidation preference. This means that the value of the participating preferred is always higher than that of convertible preferred with the same number of shares (see $\Delta V$ in Figure 2). It also means that the participating preferred always receives some return above the value of the initial investment (as long as there is sufficient enterprise value to cover all of the liquidation preferences). Participation, in effect, requires that the entrepreneur transfer to the investor a share of the enterprise value built up by the entrepreneur prior to the investment. That value transfer is equal to the enterprise value multiplied by the new share of ownership of...
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**Tradeoffs**

In comparison to convertible preferred stock, a participation feature shifts value from the entrepreneur to the investor. Therefore, it would be reasonable for the entrepreneur’s management team to propose that the VC accept fewer shares if the participation feature is to be included in the deal structure. This is illustrated in Figure 3. If a lower number of shares is associated with the participating preferred, then the investor is trading off greater downside protection against decreased upside potential.

Paradoxically, the traditional convention of deal valuation of using fully converted shares to value the company, the fewer shares associated with the participating preferred structure will give the enterprise a higher valuation for the same level of investment.

In addition, a participation provision extracts value from a firm from the first moment of the financing. If a firm is liquidated at any value above the liquidation preference, the holder of participating preferred stock will receive his liquidation preference and will participate in the value that remains. Even if the firm is sold for a valuation less than the valuation implied by the conventional deal valuation based on fully diluted shares, the holder of participating preferred receives his investment plus a return—even if the sale should occur very shortly after the financing event.

**Conclusion**

The continued prevalence of a participation feature in deal structures today indicates that the VC community either has less confidence in the potential growth of portfolio companies or a lower appetite for risk in a post-bubble environment. This continued frequent use of participation provisions is consistent with the shift toward later stage investing by many VCs in which expected returns are lower but so are the risks.

The use of participation has an important additional effect in that it sets a precedent for terms in subsequent financing rounds. Later round investors will insist on participation and seniority in liquidation preferences as well. This insistence on participation by new investors in the follow-on rounds represents an immediate claim on the value already established by the company as part of the price of bringing in the new capital. This means that the VCs who funded the earlier rounds and whose investments formed the basis for the value creation up to the point of the new round will now have to transfer some of that hard won value to the new investors. Thus, the early round investors may come to view the value transfer caused by participation to be just as unattractive as the entrepreneurs likely saw that same type of transfer to the initial investors in earlier financing rounds.

In a recovering market, participation provisions should go the way of the other post-bubble risk reduction mechanisms. Use of these provisions signals a lack of confidence in the portfolio company, affects the risk/return tradeoff for VCs, and adversely affects incumbent investors’ value when future rounds of financing are required. It is time that this feature is recognized to be as inappropriate as the other risk-shifting features that have already largely disappeared.


**Footnote 2:** In Figure 2, once the enterprise value is greater than the post-money value $V_0$ (see region A), the value of participating preferred is always higher than the value of convertible preferred by a constant increment $\Delta V$. This increment is equal to the share of ownership of the common shareholders multiplied by the initial venture capital investment, as follows:

$$\Delta V = \frac{(V_0 \cdot I_0)}{V_0} \times I_0$$

Notice that the right side of this equation can be rearranged to represent the investor’s share of ownership times the pre-money valuation, as follows:

$$\Delta V = \frac{I_0}{V_0} \times (V_0 \cdot I_0)$$

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