GUNDERSON DETTMER CATALYZE

Resource

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With the macroeconomic uncertainty and slowdown in deal activity that characterized H2 2022 and 2023, growth stage companies are feeling significant valuation pressure from investors. Companies may prioritize a strong headline valuation not only for the market signaling, but also to avoid additional dilution from triggering anti-dilution adjustments on existing preferred stock. While some companies are opting for investment structures that aren't pegged to a current valuation, the return characteristics that are often embedded in such convertible securities may seem especially onerous for companies with longer time horizons to liquidity. However, there are aspects of these structured return terms that companies are finding palatable in priced equity rounds, resulting in nominally "up" or "flat" rounds, but with added economic incentives and control terms for investors.

Warrants

Investors purchasing preferred stock also receive warrants to purchase additional shares of preferred stock or common stock. The exercise price is typically either a nominal amount (e.g., $0.01) or the price of the current round, but can be negotiated (for example, the lower of the current round or any subsequent rounds).

Most often these warrants are "penny warrants," meaning an exercise price of $0.01. These warrants provide an investor with more equity for (essentially) the same price, so they are effectively just a valuation adjustment by another mechanism. These type of warrant issuances will typically still trigger anti-dilution adjustments for existing preferred stock, although companies avoid the "down round" label and potentially better external optics.

Senior Liquidation Preference

Senior, as opposed to pari passu, liquidation preference to ensure that new invested capital will be returned first in any transaction triggering the distribution waterfall.

While it is true that junior equity does not receive proceeds until liquidation preferences are paid, if proceeds are more than the aggregate liquidation preference of investors, preferred stockholders will convert their shares into common stock and consideration will be allocated among all stockholders based on their as-converted ownership percentages.[1] Because liquidation preferences typically don't determine the allocation of proceeds except in distressed sale scenarios[2], a security with payment seniority functions primarily as a downside protection for investors. Some form of preferred payment preference relative to common will virtually always be present in order to preserve a lower valuation for the common stock and protect investors in downside scenarios. So the question is really whether the new preferred is senior to all other preferred and whether the parties want to set this precedent with the financing, increasing the likelihood that future investors will require the same and subordinate the current series of preferred in later rounds. Note that typically a company will need current preferred stockholder approval to create a senior security (due to protective provisions), so it is important to speak to large stockholders early in the process to ensure alignment.

Multiple Liquidation Preference

Preference that exceeds invested capital (e.g., 1.5x or 2x). Junior equity receives nothing until such return is paid.

We're seeing an uptick in liquidation preference multiples, although this is still considered a very investor-favorable term and is present only in a small minority of deals. As with payment seniority, multiples are downside protection since liquidation preferences are no longer applicable once it is more economically favorable for the preferred to convert to common. However, the use of multiples increases the threshold at which the preferred will choose to convert, which effectively increases the range of deal proceeds in which junior equity (e.g., common stock) receives nothing. This term also carries precedent-setting risk for later rounds, resulting in a "compounding" liquidation preference weighing over the company's common stock. Before agreeing to any liquidation multiples, companies should prepare thorough liquidation models to understand the financial impact of those preferences across various exit scenarios.

Cumulative Dividends

Annual dividend, typically reflected as a percentage of invested capital (e.g., 5% of the "original issue price"), which continues to accrue when unpaid. Dividend rate can increase or decrease based on the passage of time or specified event triggers. Can be paid in cash, or paid in kind (PIK) in common stock or additional preferred.

For companies, an equitable argument for dividends is that, while liquidation preference multiples apply as soon as the shares are issued, accruing dividends account for time invested and therefore convey benefits more precisely. From an investor's perspective, these same timing effects add more variability to expected return calculations. However, unlike liquidation preference multiples, which only impact downside scenarios, cumulative dividends increase investor returns in successful exits as well, as accrued dividends are typically included in liquidation preferences (e.g., 1x preference would mean the repayment of invested capital, plus all accrued and unpaid dividends) and redemption prices or, less commonly, paid on conversion of preferred. As such, cumulative dividends are considered very investor-friendly and are uncommon in venture capital deals. Companies should carefully consider how dividends (especially PIK dividends) can increase aggregate liquidation preferences and investor ownership over time.

Full-Ratchet Anti-Dilution Protection

Conversion price of preferred stock will be adjusted to match any lower price used in a future equity issuance. Can be limited to a certain time period (e.g., 1 year after *issuance of the preferred) or to specified events or transactions (e.g., an IPO).*

Lowering the conversion price of existing preferred increases the number of shares of common stock issuable upon conversion of the preferred, protecting investors against dilution by adjusting their as-converted ownership. Similar to penny warrants, anti-dilution adjustments increase ownership without additional consideration and so can effectively function as valuation adjustments. While typical weighted-average adjustments protect investors from some dilution for lower-priced issuances, a full-ratchet adjustment results in all dilution from the new issuance being shouldered by the holders of common and any unadjusted preferred. Note though that the adjustment only affects as-converted ownership; it does not change the number of outstanding preferred shares and or an investor's liquidation preference. Thus anti-dilution adjustments only impact upside scenarios, or scenarios when the holder of preferred stock would choose to convert preferred shares to common.

While not typical, we are seeing full-ratchet protection used by investors for a set period of time following a financing as a way to backstop risks incorporated into their valuation assumptions. For example, adjustments might be triggered by increases in a financing round size after the initial closing, a company's failure to achieve revenue projections, or unfavorable outcomes on matters identified in diligence. For items like these, anti-dilution protection is often baked into the financing agreements via a commitment to issue additional shares to the affected investors, an approach which requires the parties to define the variables (i.e., the scope of protection) and agree on adjustment calculations at the outset of the investment. Note that the issuance of additional shares in this scenario could be a taxable event for the recipient, so the parties should take care to understand and account for the tax implications of any negotiated adjustments.

Participating Preferred

After receiving liquidation preference, preferred participate pari passu with common in distribution of remaining proceeds. Participation can be capped (e.g., preferred participate with common until they receive 3x) or uncapped ("fully-participating" preferred).

The discussion of liquidation preference above has assumed that preferred stock is non-participating, meaning that, if the preferred stock is not converted to common, the preferred investors receive their liquidation preference but do not share in any additional proceeds paid to common holders. Adding a participation component to the preferred stock either raises the threshold at which the preferred will choose to convert to common (if participation is capped), or obviates the choice entirely (for fully-participating preferred). This expands the range of deal values in which investors will take their priority return–diverting all payments from common stockholders—and significantly increases investor returns in upside scenarios. For this reason, participating preferred is probably the least common of the terms discussed in this article, and fully-participating preferred is rarely accepted by companies (or requested by investors). As with dividends and preference multiples, any companies considering participating preferred should thoroughly model the impact to other equity holders across various exit scenarios.

Investor Protective Provisions

Series-level consent required for items that may compromise investor returns or waive negotiated protections, including M&A events that result in payments below liquidation preference (or below a negotiated return for investor), waivers of preferred anti-dilution protections and conversion of preferred into common in a recapitalization or low-value exit event.

The interests of stockholders often diverge as their investment profiles diverge. Series-level consent requirements can help ensure that the interests of new investors purchasing at higher valuations are protected from impairment by unaligned stockholders with different financial interests. To the extent that stockholders in the same series have different "blended prices" (taking into account the prices paid across all equity holdings in the company), investors might seek more specific consent protections for a particular series.

Concurrent Secondary Transactions

Investors purchase preferred stock from the company and also offer to purchase shares directly from existing equity holders. Can include rights to exchange shares that are purchased for new/latest preferred.

Secondary purchases and tender offers present companies with a variety of factors to consider and are discussed in more detail in the article, "Tender Offers: Threshold Terms to Consider." We'll note here that the benefits for a company in being able to provide liquidity to founders, employees and/or early investors might balance out some less favorable terms of the primary investment. Secondary purchases are often done at a discount (typically, 10-25%) off the price of new preferred, especially if the shares being purchased are common stock. Splitting an investment between a primary purchase and a discounted secondary component reduces the investor's average purchase price, which can increase flexibility on the primary valuation.

While the discussion above covers some of the terms we're seeing as a direct response to valuation pressure, this is not an exhaustive list of options for companies and investors. Parties may also be very interested in evaluating terms such as traunched investments, redemption rights or IPO allocation covenants. In Q3 2023 alone, Gunderson Dettmer attorneys represented companies and investors in a total of 237 financings valued at $7.2 billion, earning us a #1 ranking for venture capital law firms in PitchBook’s Global League Tables, and providing our team with unmatched experience and current market intelligence on these deals. If your company is considering a financing and you are interested in hearing our insight, we encourage you to reach out to a Gunderson contact to continue the discussion.

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[1] The threshold for conversion is higher when the preferred has a participation component, but participating preferred is uncommon (see “*Participating Preferred*” section).

[2] This is an oversimplification to some extent, since liquidation preferences can influence things like the allocation of escrow, which can determine the timing of payments, even in deals where the preferred has all converted to common.

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