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Portfolio Valuation Whitepaper

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Assessing the Worth of Liquidation Preferences Amid Market Declines

How do prior liquidation preference rights hold up in down-round financing events?

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The bull market run for VC investments over the 2010 to 2021 period saw the rise of the unicorns, expanded growth and significant capital allocated to the venture sector. Coming out of COVID, this environment has shifted dramatically. Over the past decade, liquidation preferences (LPs) and related rights were certainly still considered, but their importance quickly faded as growth and value increased dramatically. At this point, it may be worth revisiting the preference terms and their impact on the estimation of fair value in a more challenging environment.

In 2024, many startups raised funds at flat or lower valuations (down rounds) compared to the elevated levels seen in 2021, regardless of their stage or size. However, investors are now favoring certain sectors like AI, healthcare and renewables, as well as leaner startups with clear paths to profitability, over those focused solely on growth. Since 2023, there has been an increase in insider and bridge rounds of financing due to higher cost of capital and macroeconomic uncertainty. Facing challenges in raising new capital, companies with imminent liquidity issues are compelled to secure funds through down rounds, which negatively impact the equity stakes of founders, employees, and previous investors. However, some founders and company owners are attempting to avoid the recognition of a declining headline value through various financing strategies:

- Use of convertible securities
- Specialized terms
  - Senior and increasing preferences
  - Material cumulative dividends
  - Minimum MOIC (Multiple of Invested Capital) or IRR (Internal Rate of Return) terms
  - Qualified events or contingent ownership coverage
  - Participation rights
  - Better than one conversion ratios
- Issuance of SAFEs (Simple Agreements for Future Equity) with or without caps
- More aggressive, tranched financings with embedded contingencies for capital calls

All of these strategies are dilutive and typically indicate a decrease in value; however, from a basic viewpoint, these strategies enable the reported headline values or original issue prices to remain high while obscuring the true impact they have on the value of a company.

Downside Protection for Equity Investors

LPs help mitigate financial risk for new investors, making high-risk ventures more appealing. They serve as a crucial negotiating tool, enabling investors to secure better terms during future funding rounds and allocation of value at certain exit scenarios. LPs can influence a startup's valuation, as some investors may demand higher returns, potentially lowering the overall valuation. High LPs can deter new investors since they guarantee higher returns for current investors during a liquidation event. LP can skew the perceived value of the company. For example, a startup with a $250 million valuation, $100 million in preferred stock and a 2.0x LP might end up being worth much less to common shareholders in a liquidation scenario.

A significant amount of LP can create “flat spots,” where certain investors become indifferent to the company’s final sale price across various outcomes. Therefore, negotiating fair and equitable LPs is essential for investors and founders. Both parties can consider several factors while negotiating LP:

- Stage of development (early stage vs. mature stage)
- Expected capital needs of the company to get to exit or profitability
- Market conditions
- Valuation of the company
- Exit strategy

In tough economic times, securing investment—even with senior LPs—can be vital for a company’s survival. Without this funding, the company might face severe financial challenges or even bankruptcy. Although LPs safeguard current investors, they might discourage new investors if the terms seem too advantageous for existing investors. This can affect the company’s ability to secure future funding rounds. LPs also shape investors’ perspectives on exit strategies. Those with strong LPs may advocate for earlier exits to recover their investments, whereas investors with weaker LPs might prefer to wait for a higher valuation.

For junior and common shareholders, having senior investors with LPs can provide a buffer against downside risk. These investors are more likely to support the company during difficult periods. If the company succeeds and grows, the overall value can increase, benefiting all shareholders, including junior and common shareholders. They may be comfortable with senior LPs for new investors who invest at higher valuations compared to previous rounds. High or favorable LPs can sometimes reduce the company’s valuation by prioritizing preferred investor returns over those of common shareholders. This can dilute the value of common equity, impacting the returns founders and employees receive during an exit, especially in low-value scenarios such as asset sales or distressed mergers.

In companies with complex capital structures, LPs determine the order of payouts during a liquidity event and can significantly influence the distribution of proceeds, which, in general, disproportionately benefits preferred stockholders relative to their percentage ownership in the company. Understanding the impact of different types of LPs on a company’s value is crucial, as they can affect financial outcomes during exit events.

Non-participating LPs typically lead to higher company valuations as compared to more favorable LP. They provide a single payout to preferred shareholders first, with the remaining proceeds going to common shareholders.

Participating LPs, on the other hand, can result in lower company valuations as preferred shareholders get their LP first and then share the remaining proceeds with common shareholders, reducing the amount available to common shareholders and diluting their equity value.

Dynamics of Down Round

In the landscape of startup financing, down rounds—where new shares are issued at a lower valuation than the previous funding round—have traditionally been met with concern by companies and investors. Historically, down rounds have been wrongly associated with struggling or distressed companies, leading to decreased employee morale, ownership dilution and a challenging future. However, the bull market, driven by low interest rates and excess supply of capital, created a scenario where robust businesses have valuation multiples significantly higher than those of comparable public companies, even when adjusted for growth. Consequently, we are witnessing a situation where securing new financing with favorable terms is becoming more difficult, forcing companies with immediate liquidity needs to raise funds at lower valuations. The question to answer is how prior LPs hold up in down-round financing events, and what the impact should be of new terms on previously protective rights?

In a down round, the terms for existing investors can be restructured, often enforcing a "pay-to-play" provision. This means preferred stock investors may face penalties, such as higher dilution or reduced seniority, if they do not invest a specified amount in future financing rounds.

To better understand the effects of down rounds, examining real-world examples can be insightful. Here are a few case studies that illustrate how these concepts are applied in practice:

1 Klarna

The Swedish fintech company Klarna, known for its "buy now, pay later" services, faced a significant down round in 2022. Its valuation, which was $45.6 billion in June 2021, dropped to $6.7 billion by July 2022, marking an 85% decline. This was due to a severe market downturn, high inflation, rising interest rates and increased losses. In response, Klarna diversified its financial products, implemented cost-cutting measures, and expanded into key markets, particularly the U.S. At the end of March 2025, Klarna was trading at a valuation of $14 to $15 billion in the secondary market and was considering an IPO in H1 2025 which has been put on hold amid US tariff concerns.

2 WeWork

Once valued at $47 billion, WeWork's business model came under scrutiny before its failed IPO in 2019, leading to a significant drop in valuation. As part of a bailout package from SoftBank, WeWork's existing investors were given the option to either sell their shares at a lower price or receive additional shares with an LP, placing them ahead of SoftBank in the event of liquidation.

3 Paytm

One 97 Communications Ltd, the parent company of Paytm, went public in 2021 with a $20 billion valuation. However, its stock fell over 28% on debut and lost more than 75% of its value by March 2022. Since 2018, Paytm has faced significant regulatory challenges from the RBI (Reserve Bank of India), intense competition, strategic missteps, cybersecurity lapses and regulatory crackdowns, especially related to Chinese ties. Major investors like SoftBank, Ant Group, and Berkshire exited their stakes, reflecting declining investor confidence. In H2 2024, however, Paytm shares demonstrated resilience and recovered over 75% due to improving business prospects and clearance of regulatory hurdles, which boosted investor sentiment and confidence in its growth potential.

These case studies illustrate the complex dynamics of down rounds and demonstrate how companies can recover from valuation slumps by pivoting their business strategies.

Enforceability of LP

Preferred and common stockholders often have conflicting interests in exit transactions due to LPs. Preferred shareholders might favor lower-risk, lower-value strategies to safeguard their LPs, while common shareholders may prefer higher-risk, higher-value strategies. Unless preferred stockholders have contractual rights to force a sale or put their stock to the company, most exit sales fall under the board's discretion. The Board of Directors owes fiduciary duties to the corporation and its stockholders, but these duties can vary based on the class of stock. Directors must aim to maximize the corporation's value for its residual claimants, typically common stockholders, rather than contractual claimants like preferred stockholders. Preferred stock rights are contractual, and directors do not owe fiduciary duties to preferred stockholders when making decisions that might affect their contractual rights.

LPs are usually paid in situations beyond the board's control, such as bankruptcy, insolvency, or a forced sale by a shareholder. Viewed in isolation, a preferred stock's LP is similar to a priority debt claim on the firm. When junior shareholders control the timing and mode of an exit, enforcing LPs can be challenging, as they might structure the transaction to minimize payouts to senior preferred shareholders. However, the enforceability of LPs is upheld by contractual agreements, judicial precedents, fiduciary duties, regulatory oversight and potential legal recourse. The enforceability of exit clauses in shareholders' agreements is crucial for investor confidence and effective corporate governance. Key mechanisms— including tag-along rights, drag-along rights, and IPO provisions—require precise drafting to address enforceability challenges, as highlighted in the following case studies where investors successfully exercised their LPs.

1 Trados

Founded in 1984, Trados specialized in document translation software. During the 2000 internet bubble, it was valued at $14 million and aimed for an IPO. However, post-bubble, it failed to meet investor expectations. In 2005, Trados was sold to SDL plc for $60 million by the board. Preferred shareholders received $52.2 million and management got $7.8 million through a management incentive program. Preferred stockholders, with a 1.0x LP and an 8% cumulative dividend, had rights worth $57.9 million at the time of sale, leaving common shareholders with nothing. Marc Christen, a common stockholder, sued the board for breaching fiduciary duties. After eight years, the court ruled that the sale was fair, noting that there was no financial loss to common shareholders and no better alternative available. However, the court stressed that boards should give precedence to the interests of common stockholders over the specific rights of preferred stockholders.

2 Nine Systems

Nine Systems Corporation, a streaming media company, underwent a recapitalization in 2002, sharply diluting common stockholder equity from around 26% to 2%. In 2006, Nine Systems was sold to Akamai Technologies for $175 million. Preferred VC stockholders received about $150 million, while common stockholders got around $3 million. Minority shareholders challenged the recapitalization, alleging the board failed to obtain an independent valuation and had not disclosed key terms. In 2014, the court found the transaction resulted in a fair price but deemed the process “grossly unfair” due to the lack of independent valuation and inadequate disclosure.

3 Instacart

Instacart's IPO in September 2023 led to substantial losses for preferred investors. The company's valuation plummeted from about $39 billion in its 2021 funding round (Series I) to around $10 billion at the IPO. Consequently, LPs did not offer downside protection to preferred shareholders during the IPO, as all share classes were converted to common shares and proceeds were distributed on a pro rata basis.

When a company undergoes a down round, the LPs of previous investors can become a significant burden. If the company is sold at a lower valuation than the previous funding round, investors with LPs are entitled to recoup their full investment before any other shareholders receive any proceeds. This scenario can result in common shareholders receiving little to no benefit from the sale, impacting the equity positions of existing investors, founders and employees. Such situations can raise concerns about breaches of fiduciary duties and the liability of controlling shareholders.

Actual Value of LP

Funds often struggle to understand how their preferred investments, which have an LP greater than 1.0x and senior claims, could be valued below cost, even in an underperforming business. This difficulty arises mainly because they place significant emphasis on downside protection, overlooking potential conflicts with common shareholders, as shown in previous case studies. These case studies also highlight that enforcing LPs can be complex, despite their contractual nature, due to conflicts between preferred and common shareholders. The Board of Directors' fiduciary duty is to ensure the sale transaction is entirely fair, in terms of fair dealing and fair price, as per state law in majority of the US states. Therefore, investors should correctly price in the value of downside protection attributed to LP at the time of investment. A 1.0x LP at entry combines value ascribed to downside protection and upside returns. For example:

1.0x LP at Entry = Downside Protection (about 0.6x) + Upside Return (about 0.4x)

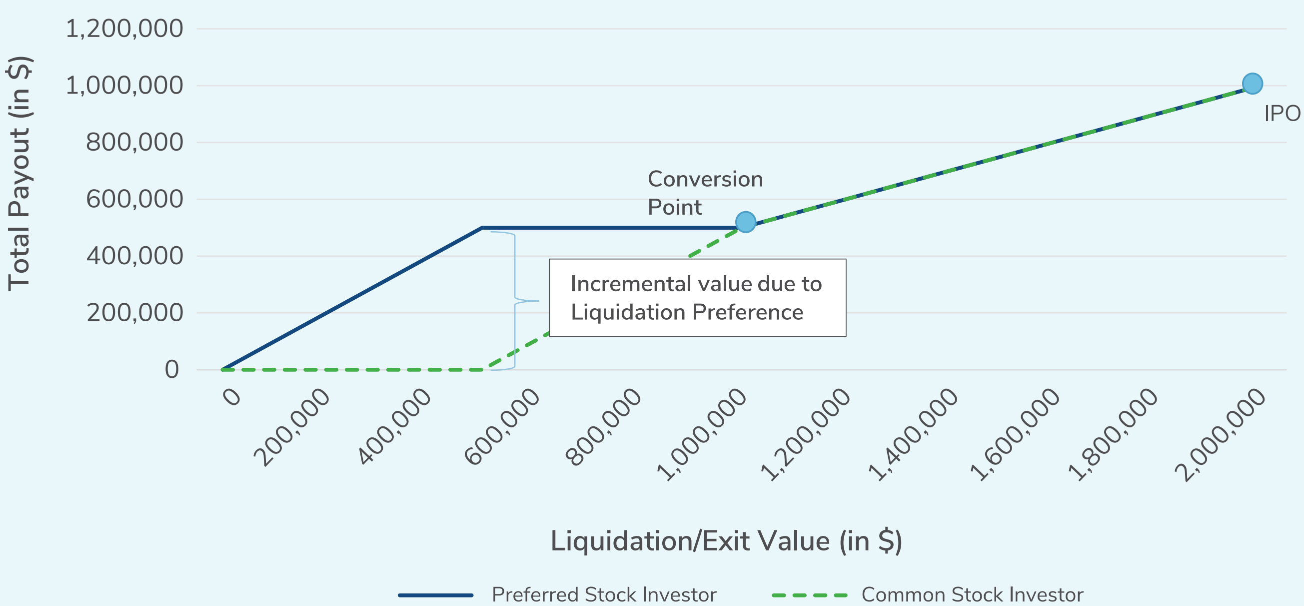
If the company raises new funding through a down round, the value of the fund's investment would hypothetically decrease to 0.8x, rather than staying at the initial investment cost despite a 1.0x LP. This is because the value attributed to the two components of the LP would change as follows:

0.8x Fund's Holding Value in Down Round = Downside Protection (about 0.7x) + Upside Return (about 0.1x)

Thus, the value of downside protection increases during a down round for preferred shares. It is more than offset by the decrease in value attributed to upside return expectations, resulting in a net decrease in the overall value of the fund's stake.

Refer to the below chart for a typical payout structure of non-participating convertible preference shares compared with the payout of a common stock investor without any LP.

Waterfall Distribution with Non-Participating and Convertible Preference Shares



According to the AICPA, the hybrid method, which combines scenario-based methods and the Option Pricing Method (OPM), can be a valuable alternative for situations where a company has insight into one or more near-term exits but is uncertain about the outcomes if current plans do not materialize. The OPM treats common and preferred stock as call options on the company's equity value, with exercise prices based on the LPs of the preferred stock. This method leverages the conceptual framework of option pricing theory to model a continuous distribution of future outcomes and capture the option-like payoffs of various share classes while also explicitly considering future scenarios and the discontinuities that early-stage companies often face. Due to their downside protection and priority claim on the company's assets over common shareholders, preferred shareholders typically experience a smaller decline in value compared to the overall drop in the company's valuation. This approach can be further supported by using a hybrid method to value a fund's investment in an early-stage company with a complex capital structure.

Funds often include a 1.0x LP, even if the downside protection might not hold significant economic value. It is not in the fund's best interest to forgo negotiating this preference when it is standard practice. Early-round LPs typically don't have a direct economic impact due to the need for multiple financing rounds to achieve high valuations. They ensure that recent investors hold seniority and a larger share of the total value. This seniority grants them influence over future financings and exit transactions, particularly when the company is underperforming.

In essence, LPs become crucial during low- to mid-value exits. Kroll can assist with developing valuation frameworks that withstand challenges and can document supportable reasons for heightened consideration in the valuation of downside protection.

Conclusion

Overall, in 2024, the startup financing landscape shifted toward lower valuations due to high valuation multiples and liquidity needs. Companies facing liquidity issues are often driven into down rounds, which affect equity stakes and require the negotiation of LPs to protect investors. However, enforcing LPs is complex, as enforcement is influenced by the conflicting interests of preferred and common stockholders. Preferred shareholders typically seek lower-risk strategies, while common shareholders may favor higher-risk approaches. The Board of Directors must prioritize the interests of common stockholders. Although challenging, enforcing LPs is supported by contractual agreements, judicial precedents, and regulatory oversight. Real world examples, such as Trados and Nine Systems, highlight the importance of fair dealing and the true value of LPs. Utilizing valuation methods like the hybrid method can further aid in assessing investments in early-stage companies with complex capital structures.

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