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Startups and the hoopla around their sky high valuations

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Liquidation preference gives investors a good amount of downside protection from losing money in the event of Liquidation.

In recent times, we have been fascinated by the sky high valuations of technology start-ups across the globe. Have you ever wondered, in such a short span of time, what have been driving these tech start-ups to give the publically listed companies a run for their money in terms of business valuation?

These business valuations have been driven by Liquidation Preference, a clause used in the term sheet by the investors like venture capital & private equity firms worldwide to protect their investments.

Let's understand, what exactly is Liquidation Preference?

Liquidation Preference is one of the benefits that come along with Preferred Stock which investor gets by investing in the start-up. It simply means division of proceeds between the

investors and other shareholders once a company is liquidated. Here liquidity means that a company is wound-up, acquired or sold excluding IPO or listing at a stock exchange.

Liquidation preference gives investors a good amount of downside protection from losing money in the event of Liquidation. It ensures that the investors would get their capital along with a return on their investment before any other equity shareholder. It ensures that even if the investment does not perform well, the investor will still get back its invested money.

The nature of Liquidation Preference depends on the stage at which the investment would be coming into the company. In early stage start-ups, investors protect their capital, whereas investments done at later stages attract good return which gets built into the Liquidation Preference.

Liquidation Preference can be participating preferred as well as non-participating preferred. Under Participating Liquidation Preference, the investor gets a multiple on the amount invested plus a share according to its shareholding. With Non Participating Liquidation Preference, it protects the investor from future downsides, guaranteeing their money to be returned first in case of liquidation.

The liquidation preference ranges from 1.0x (the most common) to 2.0x (a rarity).

Let’s say, a financial services tech start-up is looking to raise $100 million. The investors agreed to invest $100 million in it for a 10% stake. Theoretically, if 10% is worth $100 million, the start-up will now be valued at $1 Billion. However, investors look at it differently. For them, if the start-up is sold or acquired at $100 million or more, then they are secured due to liquidation preference. Therefore, anything above it is an upside for the investors.

If the valuations come down it can make the start-up as well as the founder’s life difficult because of liquidation preference. Higher valuation creates higher expectations, and failure to meet them can lead to a forced sale. In that event, the investors are paid first leaving founders with very less money.

Some people called it a debt, some call it protection against risk on capital and some have even gone to an extent to call it a time bomb for a start-up. We should not be conned by the fancy

headlines of sky-high valuations as it could be viewed as a debt raised by the start-up keeping the whole company as a collateral to the investors.

Hence, it would not be prudent to directly compare the valuations of public listed companies with the privately held internet firms.

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