

THE ENTREPRENEURS REPORT

Private Company Financing Trends

Q1 2015

Price and Preference: Part 2

By Herb Fockler, Partner, Palo Alto

This is the second part of a two-part article¹ on the importance of whether or not the preferred stock issued to investors in a venture financing participates upon liquidation. The first part discussed the marked shift from participating to non-participating preferred stock in recent years, which we theorized may be a consequence of an increasingly founder-friendly climate, plus possibly increased feeling among Series A investors that choosing non-participating preferred is in their own economic best interest. In this second part, we will explore why that feeling is correct.

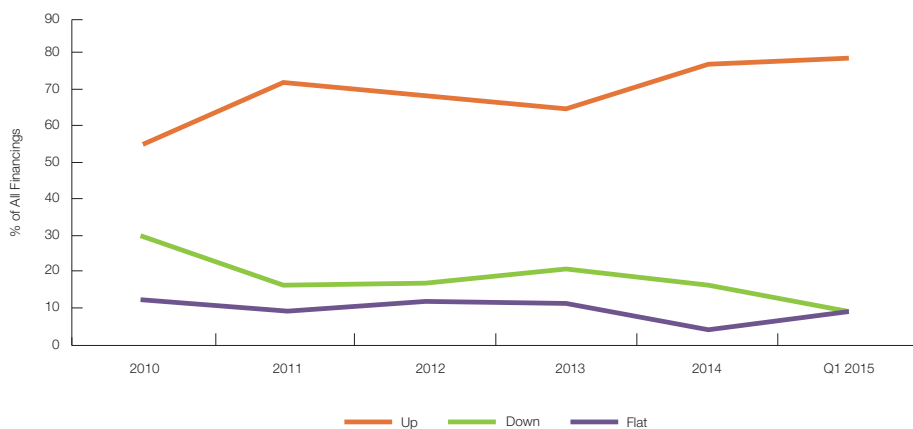
“In almost any realistic scenario, early-stage investors will do better proposing non-participating preferred.”

As discussed in Part 1, the preferred stock issued in venture financings carries a “liquidation preference.” This preference provides that upon a liquidation—or, more importantly, an acquisition—of a company, the holders of the preferred stock are first paid an amount per share equal to their original purchase price out

(Continued on page 7)

From the WSGR Database: Financing Trends for Q1 2015

Up and Down Rounds by Year - Equity Financings



Venture market activity in the first quarter of 2015 suggests that notable shifts in venture financing may be underway. Pre-money valuations were generally quite high; at the same time, the median amount invested declined significantly.

This combination of rising valuations and declining amounts raised would appear to signal an excellent market for founders. However, as reported by PitchBook and other sources, the number of venture deals has declined while the average amounts raised have

increased, even though median amounts have not.

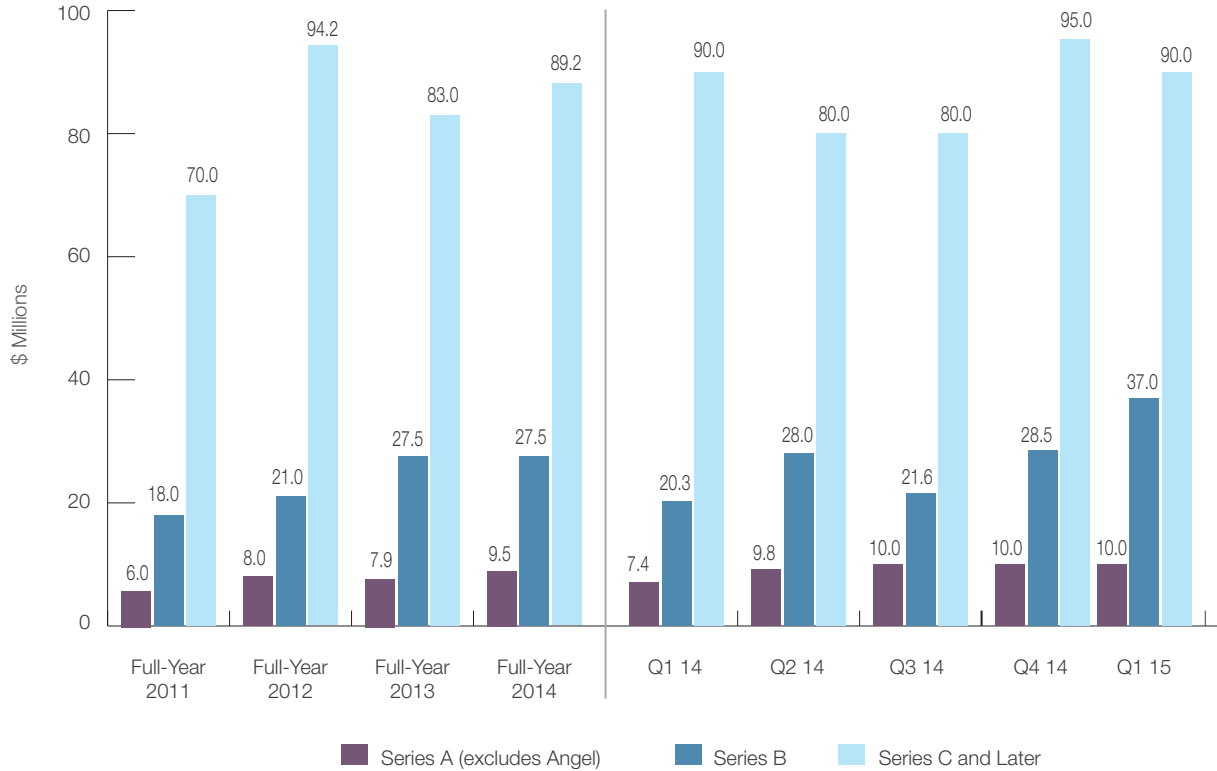
In other words, venture money is shifting to a smaller number of large deals. This shift is discussed in the article by Recursive Capital Managing Member Eric Ver Ploeg on page 14 of this report.

Up and Down Rounds

Up rounds in Q1 2015 rose to 80% of all financings, with down rounds and flat rounds each comprising 10%. The 10% figure is the lowest for down rounds for Series B and later financings since 2007.

¹ Part 1 was published in the 1H 2014 issue of *The Entrepreneurs Report*.

Median Pre-Money Valuations



Valuations

The Q1 2015 median pre-money valuation in Series A deals¹ backed by venture and corporate strategic investors remained at \$10.0 million for the third straight quarter. The Series B median pre-money valuation was \$37.0 million, higher than any quarter since 2007. The median pre-money valuation for Series C and later rounds was \$90.0 million, lower than Q4 2014 but the same as Q1 2014.

million, and the Series B median amount raised of only \$4.0 million was the lowest such figure since Q3 2012. For Series C

and later rounds, the median amount raised dropped to \$10.3 million, the lowest since Q1 2014 when it was \$10.0 million.

Q1 2015 Valuations



Third straight quarter



Higher than any quarter since 2007



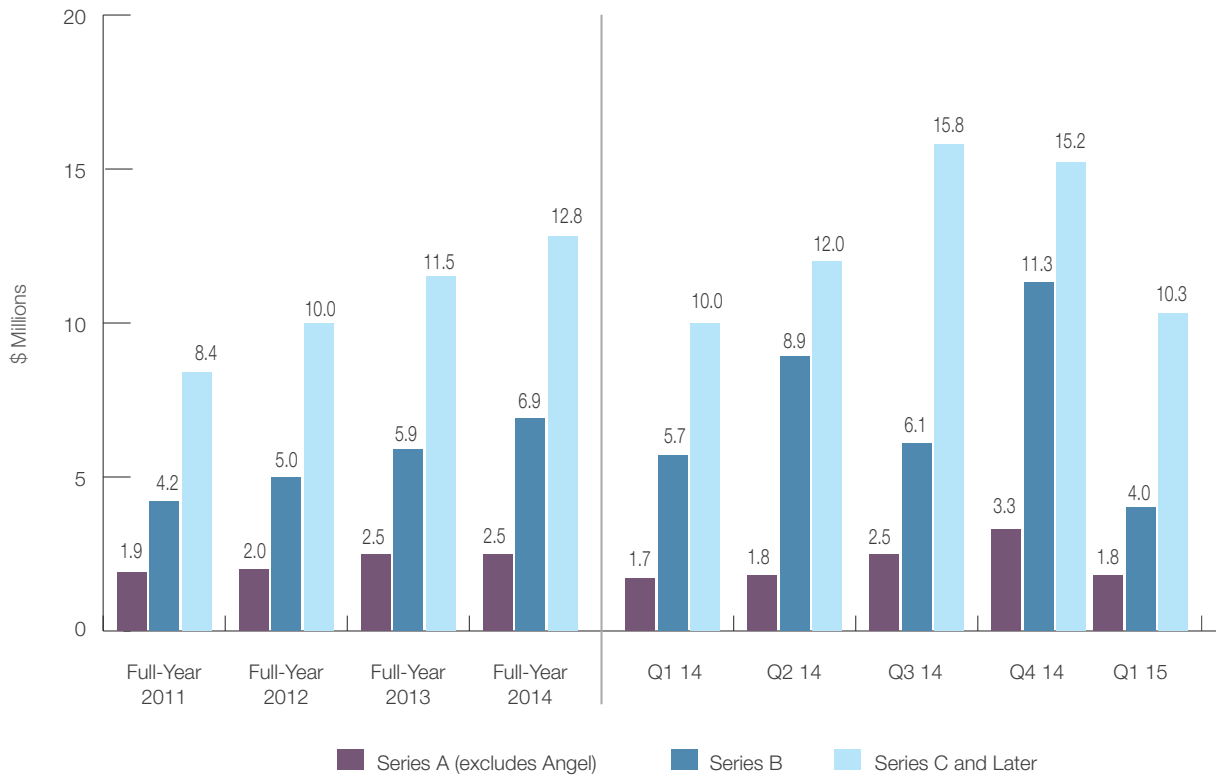
Same as Q1 2014

Amounts Raised

The Q1 2015 Series A median amount raised was a relatively modest \$1.8

¹ Seed rounds are included in this category, but we exclude Angel-backed Series A and seed rounds.

Median Amount Raised – Equity Financings



Deal Terms

Data on deal terms such as liquidation preferences, dividends, and others are set forth in the table on the next page. Please note that the low percentage of

down rounds reported for Q1 2015 resulted in a sample size that was too small to calculate meaningful deal term percentages; consequently, we did not include metrics for down rounds. We anticipate including metrics on down rounds in the mid-year 2015 *Entrepreneurs Report* when the data set will be larger.

and the use of non-participating preferred rose to 78% of all deals, up from 74% in 2014, 70% in 2013, and 67% in 2012. These latter figures confirm the trend toward non-participating preferred that we discussed in depth in the article “Price and Preference: Part I,” which appeared in the 1H 2014 issue of *The Entrepreneurs Report*.

Deal Terms – A Founder-Friendly Market?

Non-cumulative dividend use jumped from 74% of up rounds in 2014 to 92% of up rounds in Q1 2015

Usage of most deal terms fluctuated by amounts that may be little more than statistical noise. That said, there were at least two trends of note, both of which are consistent with a strong founders’ market: the use of non-cumulative dividends jumped from 74% of up rounds in 2014 to 92% of up rounds in Q1 2015,

To see how the terms tracked in the table on the next page can be used in the context of a financing, we encourage you to draft a term sheet using our automated Term Sheet Generator, which is available in the **Entrepreneurial Services** section of the firm’s website at www.wsgr.com.

Private Company Financing Trends (WSGR Deals)¹

| | 2012 All Rounds ² | 2013 All Rounds ² | 2014 All Rounds ² | Q1 2015 All Rounds ² | 2012 Up Rounds ³ | 2013 Up Rounds ³ | 2014 Up Rounds ³ | Q1 2015 Up Rounds ³ | 2012 Down Rounds ³ | 2013 Down Rounds ³ | 2014 Down Rounds ³ | Q1 2015 ⁴ Down Rounds ³ |
|---|------------------------------------|------------------------------------|------------------------------------|---------------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|--------------------------------------|-------------------------------------|-------------------------------------|-------------------------------------|---|
| Liquidation Preferences - Series B and Later | | | | | | | | | | | | |
| Senior | 37% | 41% | 40% | 40% | 30% | 38% | 32% | 33% | 56% | 47% | 68% | N/A |
| <i>Pari Passu</i> with Other Preferred | 58% | 55% | 56% | 53% | 67% | 60% | 64% | 63% | 39% | 37% | 21% | N/A |
| Complex | 2% | 3% | 2% | 7% | 2% | 2% | 2% | 4% | 0% | 11% | 5% | N/A |
| Not Applicable | 3% | 1% | 3% | 0% | 1% | 0% | 2% | 0% | 5% | 5% | 5% | N/A |
| Participating vs. Non-participating | | | | | | | | | | | | |
| Participating - Cap | 14% | 18% | 12% | 14% | 13% | 20% | 14% | 17% | 17% | 23% | 13% | N/A |
| Participating - No Cap | 19% | 12% | 14% | 8% | 20% | 10% | 11% | 8% | 41% | 30% | 32% | N/A |
| Non-participating | 67% | 70% | 74% | 78% | 67% | 69% | 76% | 75% | 41% | 48% | 55% | N/A |
| Dividends | | | | | | | | | | | | |
| Yes, Cumulative | 9% | 12% | 13% | 4% | 10% | 12% | 11% | 0% | 12% | 13% | 24% | N/A |
| Yes, Non-cumulative | 78% | 74% | 72% | 85% | 81% | 79% | 74% | 92% | 78% | 79% | 71% | N/A |
| None | 13% | 14% | 15% | 11% | 9% | 9% | 15% | 8% | 10% | 8% | 5% | N/A |
| Anti-dilution Provisions | | | | | | | | | | | | |
| Weighted Average - Broad | 86% | 90% | 85% | 79% | 90% | 94% | 90% | 75% | 85% | 95% | 92% | N/A |
| Weighted Average - Narrow | 3% | 3% | 9% | 13% | 3% | 3% | 6% | 21% | 5% | 0% | 5% | N/A |
| Ratchet | 2% | 1% | 1% | 0% | 2% | 0% | 1% | 0% | 8% | 3% | 0% | N/A |
| Other (Including Blend) | 2% | 1% | 1% | 3% | 2% | 1% | 1% | 4% | 3% | 0% | 0% | N/A |
| None | 6% | 5% | 4% | 6% | 3% | 2% | 2% | 0% | 0% | 3% | 3% | N/A |
| Pay to Play - Series B and Later | | | | | | | | | | | | |
| Applicable to This Financing | 5% | 5% | 4% | 6% | 1% | 1% | 1% | 4% | 23% | 15% | 16% | N/A |
| Applicable to Future Financings | 3% | 1% | 0% | 3% | 3% | 1% | 0% | 0% | 3% | 0% | 0% | N/A |
| None | 92% | 95% | 96% | 90% | 96% | 98% | 99% | 96% | 74% | 85% | 84% | N/A |
| Redemption | | | | | | | | | | | | |
| Investor Option | 22% | 19% | 17% | 11% | 23% | 20% | 22% | 4% | 35% | 33% | 24% | N/A |
| Mandatory | 1% | 1% | 3% | 3% | 1% | 2% | 3% | 8% | 3% | 0% | 3% | N/A |
| None | 77% | 80% | 80% | 86% | 76% | 78% | 75% | 88% | 63% | 67% | 74% | N/A |

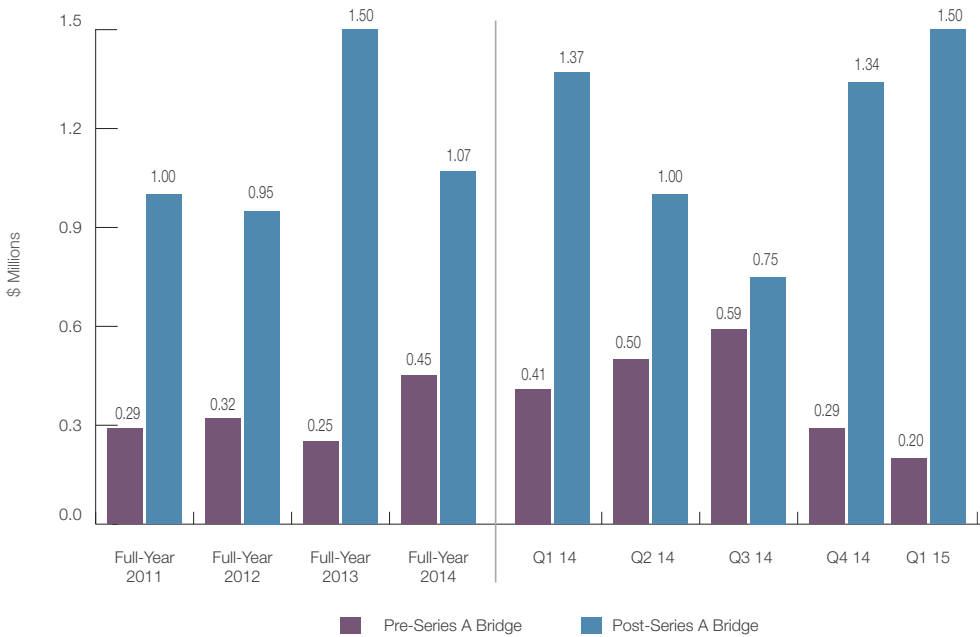
¹We based this analysis on deals having an initial closing in the period to ensure that the data clearly reflects current trends. Please note that the numbers do not always add up to 100% due to rounding.

²Includes flat rounds and, unless otherwise indicated, Series A rounds.

³Up Rounds and Down Rounds columns do not include Series A and flat rounds, making them a subset of the All Rounds category.

⁴Due to the small number of down rounds in Q1 2015, we did not calculate the deal term percentages in this category.

Median Amount Raised – Bridge Loans



Subordinated debt. The use of subordinated debt declined for both pre-Series A and post-Series A loans, constituting only 10% of the former and 29% of the latter in Q1 2015.

Warrants. The decline in the use of warrants also suggests a founder-favorable market, as well as a growing desire to simplify transaction documentation. None of the pre-Series A loans carried warrants, and only 14% of post-Series A loans had them.

Conversion. Conversion rates subject to a price cap remained popular for pre-Series A loans, at 60% of all such debt. However, the use of a price cap declined for post-Series A loans, from 23% in 2014 to 14% in Q1 2015.

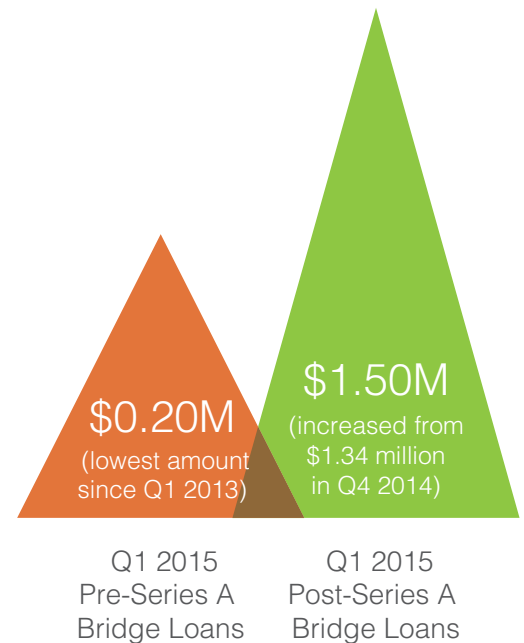
Bridge Loans

The Q1 2015 median amount raised in pre-Series A bridge financings was only \$0.20 million, the lowest amount since Q1 2013. The equivalent figure for post-Series A loans increased from \$1.34 million in Q4 2014 to \$1.50 million in Q1 2015.

Interest rates. As has been the case since we started reporting on bridge loans, annual interest rates of less than 8% for pre-Series A loans continued to be the most frequent option, with 89% of such loans in Q1 2015 having rates of less than 8%, up from 72% for full-year 2014. Rates below 8% were the most popular for post-Series A bridge loans as well; they were used in 57% of such deals.

Maturities. The percentage of pre-Series A loans having maturities of less than one year increased from 12% in 2014 to 30% in Q1 2015. For post-Series A loans, the percentage of these lower maturities increased from 24% to 43%. This decline in the length of maturities may represent a mutual belief that successful companies will find equity financing relatively quickly.

Median Amount Raised



For purposes of the statistics and charts in this report, our database includes venture financing transactions in which Wilson Sonsini Goodrich & Rosati represented either the company or one or more of the investors.

Trends in Bridge Loans

| Bridge Loans ¹ | 2012 Pre-Series A | 2013 Pre-Series A | 2014 Pre-Series A | Q1 2015 Pre-Series A | 2012 Post-Series A | 2013 Post-Series A | 2014 Post-Series A | Q1 2015 Post-Series A |
|---|-------------------|-------------------|-------------------|----------------------|--------------------|--------------------|--------------------|-----------------------|
| Interest rate less than 8% | 64% | 70% | 72% | 89% | 44% | 46% | 43% | 57% |
| Interest rate at 8% | 30% | 29% | 22% | 11% | 41% | 34% | 42% | 43% |
| Interest rate greater than 8% | 5% | 1% | 6% | 0% | 15% | 20% | 15% | 0% |
| Maturity less than 12 months | 8% | 3% | 12% | 30% | 34% | 29% | 24% | 43% |
| Maturity at 12 months | 30% | 19% | 16% | 0% | 36% | 38% | 39% | 14% |
| Maturity more than 12 months | 62% | 78% | 71% | 70% | 30% | 33% | 37% | 43% |
| Debt is subordinated to other debt | 13% | 25% | 22% | 10% | 39% | 56% | 48% | 29% |
| Loan includes warrants ² | 8% | 4% | 5% | 0% | 32% | 34% | 19% | 14% |
| Warrant coverage less than 25% | 20% | 0% | 20% | N/A | 42% | 50% | 69% | N/A |
| Warrant coverage at 25% | 40% | 0% | 0% | N/A | 33% | 12% | 0% | N/A |
| Warrant coverage greater than 25% | 20% | 100% | 80% | N/A | 14% | 38% | 31% | N/A |
| Warrant coverage described as variable or "other" | 20% | 0% | 0% | N/A | 12% | 0% | 0% | N/A |
| Principal is convertible into equity ³ | 99% | 100% | 98% | 100% | 97% | 94% | 94% | 100% |
| Conversion rate subject to price cap | 65% | 68% | 67% | 60% | 24% | 14% | 23% | 14% |
| Conversion to equity at discounted price ⁴ | 79% | 91% | 81% | 40% | 52% | 59% | 73% | 71% |
| Discount on conversion less than 20% | 17% | 17% | 10% | 0% | 15% | 16% | 25% | 0% |
| Discount on conversion at 20% | 54% | 60% | 72% | 100% | 46% | 46% | 44% | 80% |
| Discount on conversion greater than 20% | 29% | 22% | 17% | 0% | 39% | 38% | 32% | 20% |
| Conversion to equity at same price as other investors | 12% | 9% | 16% | 60% | 38% | 35% | 24% | 14% |

¹We based this analysis on deals having an initial closing in the period to ensure that the data clearly reflects current trends. Please note that the numbers do not always add up to 100% due to rounding.

²Of the 2013 pre-Series A bridges that had warrants, 33% also had a discount on conversion into equity. Of the 2013 post-Series A bridges with warrants, 24% also had a discount on conversion into equity. Of the 2014 post-Series A bridges with warrants, 38% also had a discount on conversion into equity. Due to the small number of deals with warrants in Q1 2015, we did not do the comparison.

³This includes notes that provide for voluntary as well as automatic conversion.

⁴Of the 2013 pre-Series A bridges that had a discount on conversion into equity, 2% also had warrants. Of the 2013 post-Series A bridges that had a discount on conversion into equity, 15% also had warrants. Of the 2014 post-Series A bridges that had a discount on conversion into equity, 10% also had warrants. Due to the small number of deals with warrants in Q1 2015, we did not do the comparison.

WSGR's practice is to update the numbers for each quarter of the current year as the year progresses, so figures are subject to change.

Price and Preference: Part 2 (continued from page 1)

of the assets/proceeds available for distribution to equity holders, before any payment is made to the common stockholders. If there are assets/proceeds remaining after the preferred stockholders receive their money back in full, the remainder either can be divided among both the common and preferred stockholders,² or can be distributed entirely to the common stockholders.³ The first option is referred to as “participating preferred,” while the second option is referred to as “non-participating preferred.”

Participating preferred results in investors receiving their investment back, in addition to whatever the common stockholders receive on a per-share basis. Non-participating preferred, on the other hand, forces investors to make a choice—they can receive their investment back as preferred stockholders, or they can elect to convert their preferred to common and receive the same per-share proceeds as the common stockholders. At first glance, it would appear that holders of participating preferred will always receive more than if they held non-participating preferred.

The reality, however, is that this is not always true. In fact, where there are multiple rounds of preferred stock, early-stage investors in a rapidly developing

company will almost always receive more in an acquisition if the company’s preferred stock is non-participating.

Thus, the choice between participating and non-participating preferred is an important factor in the economic return to early investors and, given the strong presumption that later rounds of preferred will maintain the general terms of the preceding rounds, this choice is often in the control of the early investors.

* * *

We start by examining the situation where Series A investors are the only investors in the company. Consider a start-up company where the founders have issued themselves two million shares of common stock. They receive a term sheet for a \$2 million Series A Preferred Stock investment at a pre-money valuation of \$6 million, resulting in the issuance of 666,667 shares of Series A at a price of \$3.00 per share.

The pre- and post-deal capitalization table is as follows:

| Series A Investment | | | | |
|---------------------|--|-------------|--|--|
| Pre-Deal Valuation: | | \$6,000,000 | | |
| Investment: | | \$2,000,000 | | |
| Price per Share: | | \$3.00 | | |

| | Pre-Deal | | Post-Deal | |
|----------|-----------|------------|-----------|------------|
| | Shares | Percentage | Shares | Percentage |
| Common | 2,000,000 | 100% | 2,000,000 | 75% |
| Series A | - | - | 666,667 | 25% |
| | 2,000,000 | 100% | 2,666,667 | 100% |

If the Series A Preferred is participating, when the company is sold, the investors will receive the first \$2 million of proceeds to be distributed (and all proceeds if they total less than \$2 million), and any proceeds over \$2 million will be allocated to the Series A and common based upon the number of outstanding shares of each. For example, if the company is sold for \$10 million, there will be \$8 million remaining after full satisfaction of the Series A’s liquidation preference. Thus, the common stockholders will receive \$3.00 per share of common (\$8 million divided by an aggregate of 2,666,667 shares of common and preferred), and the investors will receive \$6.00 per share of Series A (\$3.00 original purchase price plus the \$3.00 the common receives).

Graph 1 at the upper right on the next page shows the amounts payable to the

² According to their percentage ownership in the company.

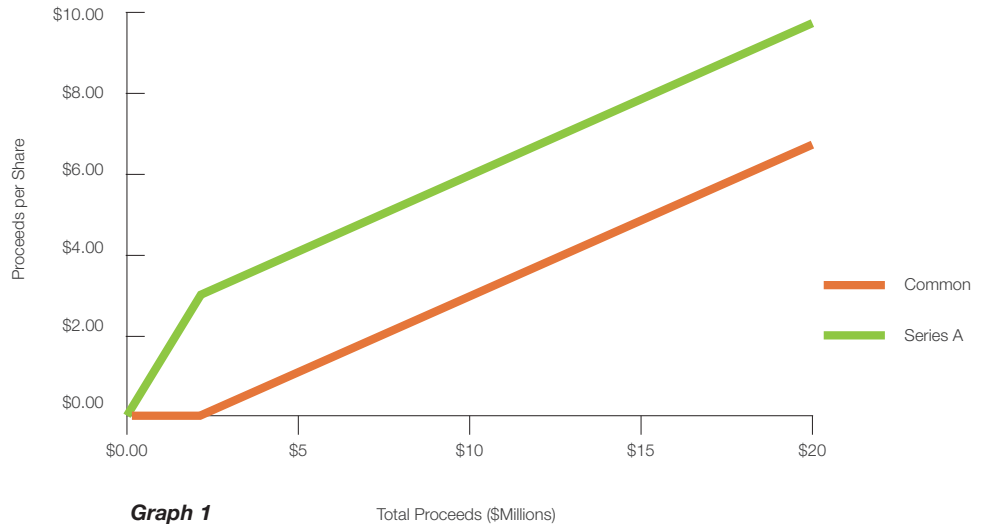
³ The remainder can also be allocated among common and preferred in a hybrid of these two methods, with the preferred participating in distribution of the remainder until they reach a specified amount, generally a multiple of their original investment.

Series A and common per share for an acquisition of the company of up to \$20 million, when the Series A is participating preferred. All proceeds are allocated to the Series A in deals up to \$2 million, and are shared by the Series A and common in the above manner for larger deals. In such case, the Series A always receives more on a per-share basis than the common, regardless of deal size.

In contrast, if the Series A Preferred is non-participating, it will entitle its holders to the first \$2 million of proceeds to be distributed, or \$3.00 per share, but no more than that, no matter how large the deal. To get more than \$3.00 per share, and share in the upside of the company, the preferred holders will have to voluntarily convert their preferred stock to common stock, thus forgoing their liquidation preference in order to get the larger return per share that the common is receiving.⁴ Graph 2 at the lower right again shows the amounts payable to the Series A and common per share for an acquisition of the company of up to \$20 million, but this time the Series A has no participation rights.

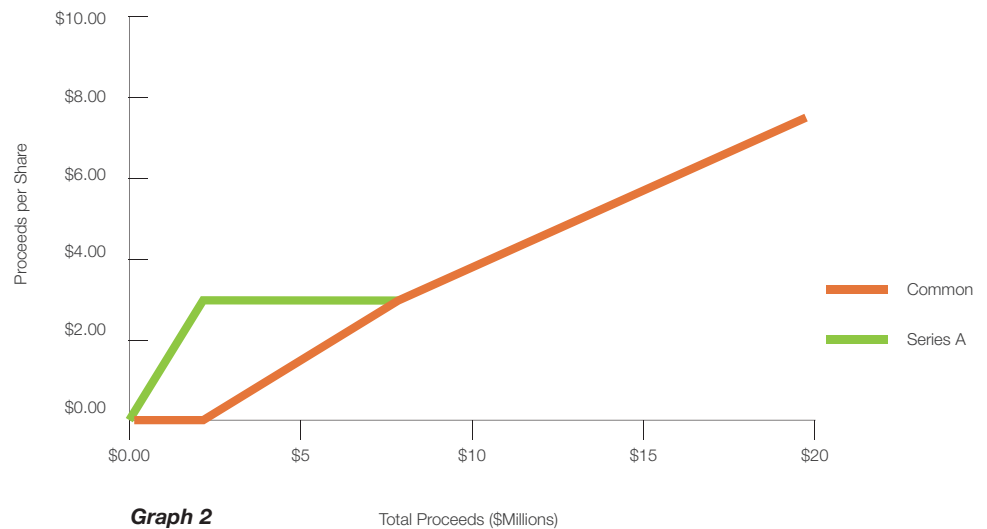
If one compares the two situations by overlaying the two graphs as shown in Graph 3 on the next page, it becomes obvious that the Series A will always do better with participating preferred when it is the only series.

Participating Preferred - Single Series



Graph 1

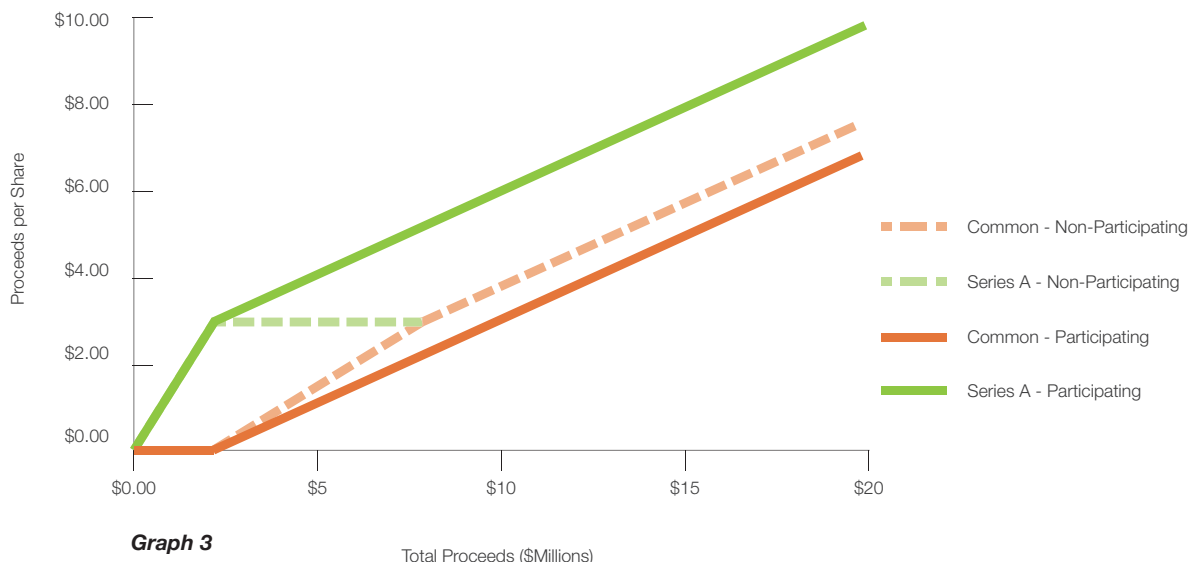
Non-Participating Preferred - Single Series



Graph 2

⁴ The common entitles its holders to nothing for deals valued below \$2 million, but everything for deals valued above that amount, and at some point—\$8 million in this case—the common will receive more per share than the Series A. Thus, for all deals valued over \$8 million, it will be more beneficial for the holders of Series A to forgo their liquidation preference and convert to common to receive that larger common amount.

Participating v. Non-Participating Preferred - One Series



Graph 3

The situation is different if the company takes in later rounds of investment, however. In fact, the circumstances are surprisingly narrow in which the Series A will receive more proceeds in an acquisition of a company with multiple series of participating preferred than one in which all series were non-participating.⁵

In general, the gain in acquisition proceeds that the Series A realizes over the common from the participating nature of their shares is more than offset by the amount it gives up to the later series of participating preferred.⁶

Consider the situation where the company in the example above is

| Series B Investment | |
|---------------------|--------------|
| Pre-Deal Valuation: | \$20,000,000 |
| Investment: | \$16,000,000 |
| Price per Share: | \$7.50 |

| | Pre-Deal | | Post-Deal | |
|----------|-----------|------------|-----------|------------|
| | Shares | Percentage | Shares | Percentage |
| Common | 2,000,000 | 75% | 2,000,000 | 42% |
| Series A | 666,667 | 25% | 666,667 | 14% |
| Series B | - | - | 2,133,333 | 44% |
| | 2,666,667 | 100% | 4,800,000 | 100% |

successful, but still needs to raise additional financing. The company receives a term sheet for a \$16 million Series B Preferred Stock investment at a pre-money valuation of \$20 million, resulting in the issuance of 2,133,333

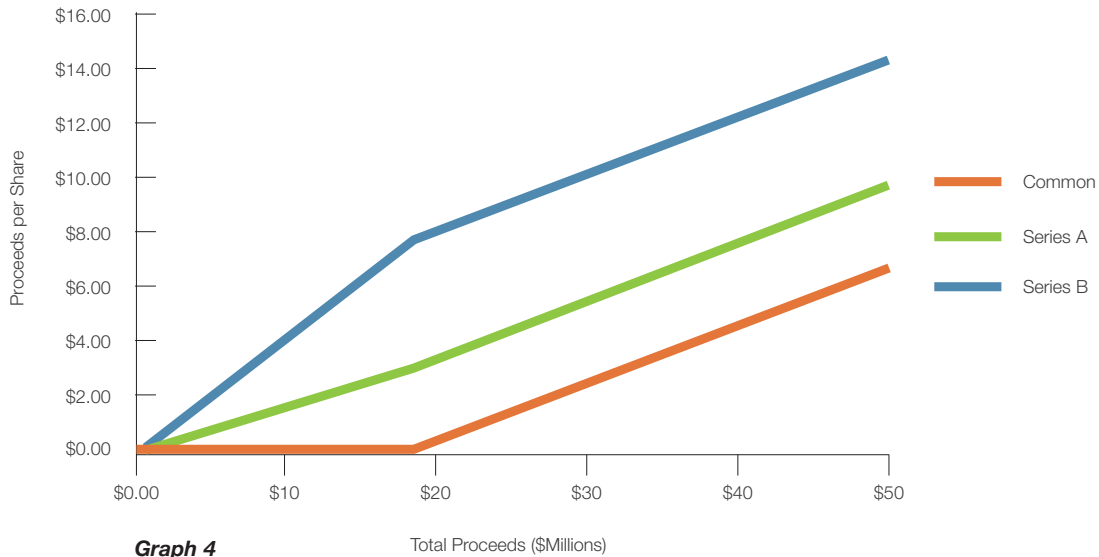
shares of Series B at a price of \$7.50 per share. The pre- and post-deal capitalization table is at left. Graph 4 on the next page shows how the proceeds per share of common, Series A, and Series B vary for acquisitions up to \$50 million where both series of preferred are participating.⁷ For deal values less than \$18 million—the aggregate amount invested by the Series A and B—the entire proceeds are allocated to the preferred in proportion to the aggregate liquidation preference of each series, with no proceeds going to the common. When the deal value surpasses \$18 million, the common begins to receive proceeds, and the Series A and B each receive (in addition to the return of their original purchase

⁵ We are assuming that all later rounds are at higher pre-money valuations than the first round. We are also assuming that either all series are participating or non-participating.

⁶ Throughout this discussion, we are assuming that the Series A and Series B investors are different persons and entities, such that the interests of each group are distinct, as would be the case where the Series A investors are angels and the Series B investors are venture capitalists. Where Series A investors are also Series B investors, the effect of participating preferred on them will be muddled, although they also may be affected by still later rounds of participating preferred in which they do not invest.

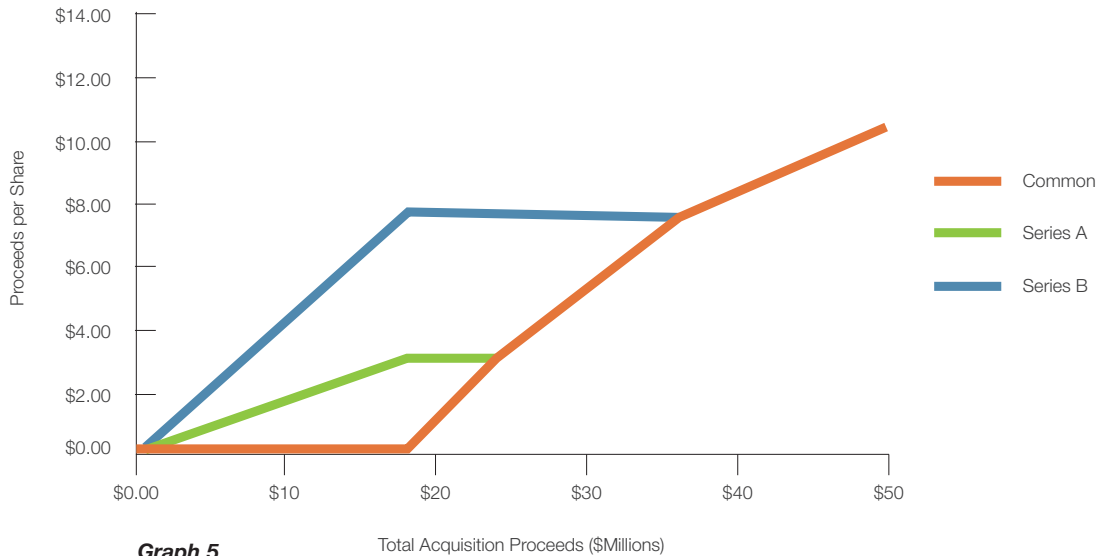
⁷ It also assumes that the Series A and Series B investors share in the proceeds on a *pari passu* basis.

Participating Preferred - Two Series



Graph 4

Non-Participating Preferred - Two Series



Graph 5

price) an amount equal to that received by the common on a per-share basis. As above, the participating nature of the preferred results in each series always receiving more per share than the common.

As shown in Graph 5 above, where both series of preferred are non-participating, the entire proceeds are

again allocated to the Series A and B, with none to the common, until the deal value reaches \$18 million. Once over \$18 million, the common is allocated all remaining proceeds, with the result that the Series A voluntarily converts to common at \$24 million, and the Series B converts at \$36 million. Thus, at deal values of \$36 million and above, the

holders of common, Series A, and Series B all receive the same amount per share.

Overlaying the two graphs again (see Graph 6 on the next page) shows the effect on proceeds per share for each series of switching from participating to non-participating preferred. The Series B clearly receives less per share, and the

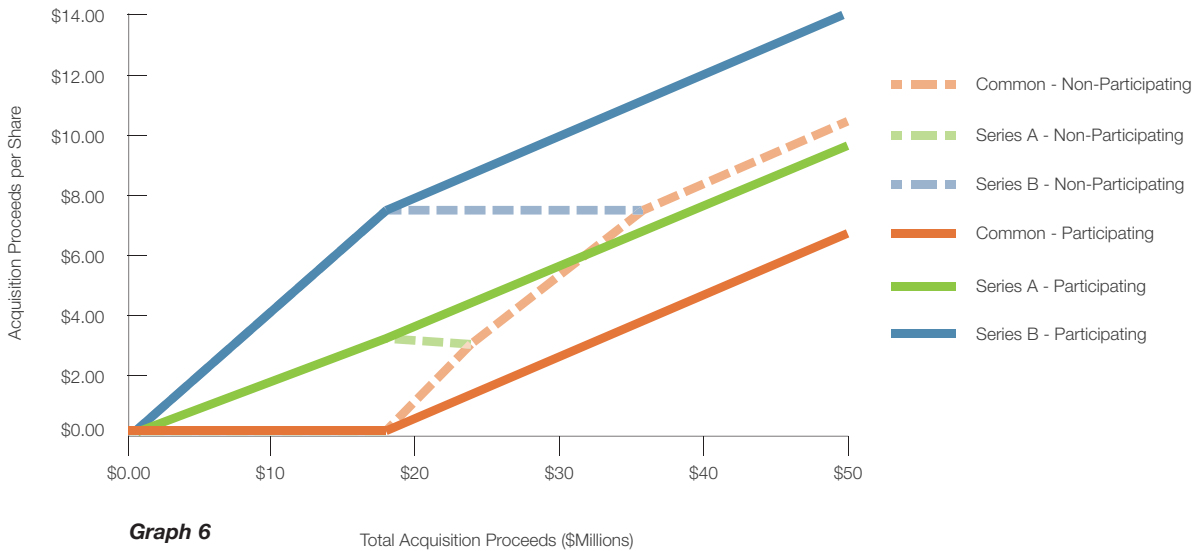
common clearly receives more. But in this particular scenario, for deals with proceeds above approximately \$32 million, the Series A somewhat surprisingly receives more per share with non-participating preferred.

The explanation for this counterintuitive result is that when moving from participating to non-participating preferred, the Series A gives up their own liquidation preference per share, but gains a pro rata share of the aggregate Series B liquidation preference (that is,

the total Series B investment amount) that otherwise would have all gone to the Series B under participation.

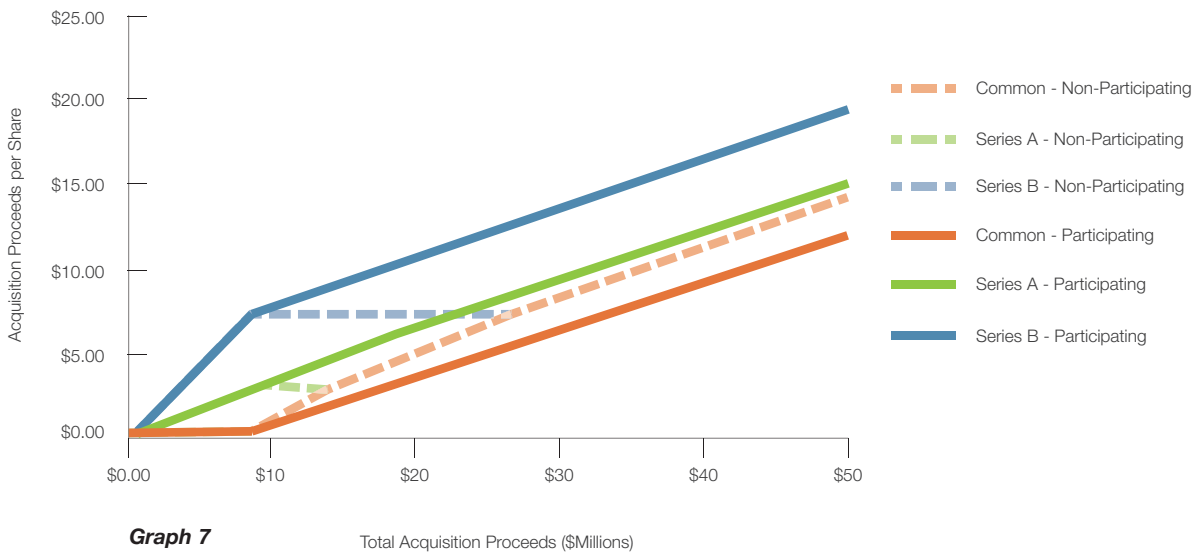
The foregoing is not true in all cases, as there are some situations where the Series A does better with both the Series

**Participating v. Non-Participating Preferred - Two Series
(\$16 Million Series B Financing at \$20 Million Pre-Money Valuation)**



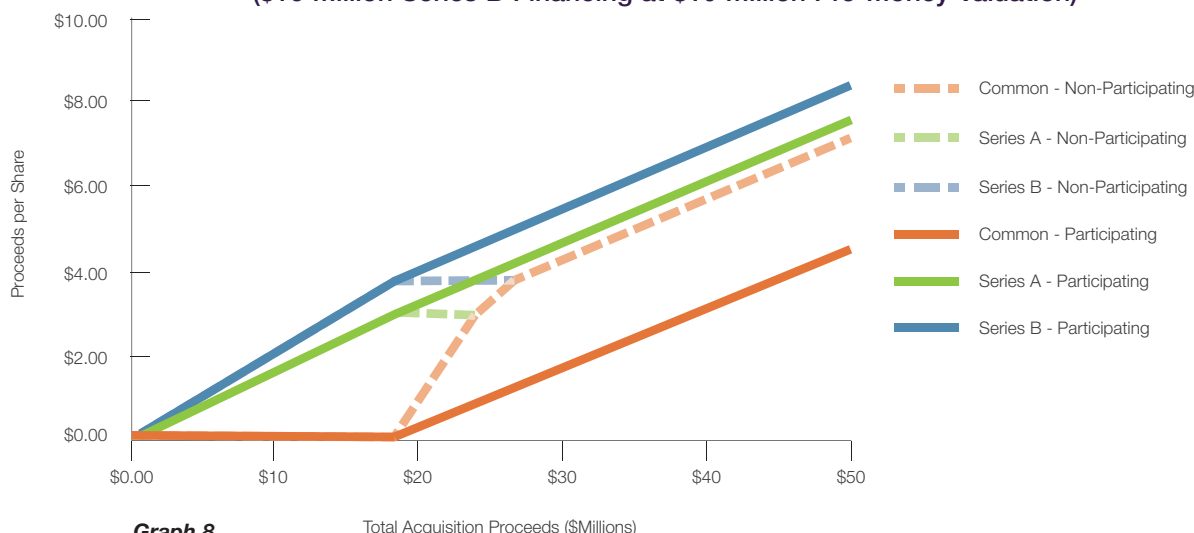
Graph 6

**Participating v. Non-Participating Preferred - Two Series
(\$6 Million Series B Financing at \$20 Million Pre-Money Valuation)**



Graph 7

Participating v. Non-Participating Preferred - Two Series (\$16 Million Series B Financing at \$10 Million Pre-Money Valuation)



Graph 8

A and the Series B participating. For example, Graph 7 on page 11 shows the comparison between participation and non-participation where the amount raised in the Series B financing was only \$6 million, rather than the \$16 million above.

The Series A also does better with both series participating when the amount raised in the Series B financing was the \$16 million in the first example, but the pre-money valuation of that financing was only \$10 million, rather than \$20 million as illustrated in Graph 8 above.

In short, the optimal economic situation for the Series A with respect to participating or non-participating preferred varies with both the amount raised in and the pre-money valuation of the Series B financing.

So when should an early-stage investor choose participating over non-

participating preferred when proposing terms for a Series A financing? As a general rule, early-stage investors in a company will do better with participating preferred only when the average price paid for all shares outstanding at the time of an acquisition is less than the price they paid per share in their Series A financing. Stated in mathematical terms, when Series A and Series B are participating, the Series A investors will have an equal or higher return at all acquisition prices only if:

$$\left(\frac{\text{Average Price of All Outstanding Shares}}{\text{All Outstanding Shares}} \right) < \left(\frac{\text{Price per Share in Series A Financing}}{\text{in Series A Financing}} \right)$$

where:

$$\text{(Average Price of All Outstanding Shares)} = \frac{\text{(Total Invested in Company)}}{\text{(Total Shares Outstanding at Time of Acquisition)}}$$

The formula above is fairly simple to apply

with hindsight at the time of an acquisition, but that is likely to be long after the Series A investors have had to choose between proposing participating or non-participating preferred. To benefit from it at that earlier time requires first-round investors to estimate not only the total amount of capital that the company will need to raise over its life, but also the total number of shares that the company will issue over multiple financing rounds.

The equation can, however, be recast in a form that can assist Series A investors at the time of the first-round financing in ruling out participating preferred, based merely upon estimates of the amount to be raised in the next financing round and the pre-money valuation of that round.⁸

For a given estimated Series B investment amount, the Series A

⁸ For simplicity, we assume that the number of shares of common stock outstanding remains constant between the financings.

investors should choose non-participating whenever:

$$\left(\frac{\text{Anticipated Series B Pre-Money Valuation}}{\text{Anticipated Series B Amount Raised}} \right) > \left(\frac{\text{Series A Post-Money Valuation}}{1 - \frac{\text{Series A Pre-Money Valuation}}{\text{Series A Post-Money Valuation}}} \right)$$

This new equation points to the underlying economics trade-off in moving from participating to non-participating preferred. As stated above, whether the Series A investors will do better or worse with non-participating preferred depends upon whether the amount they lose in giving up their liquidation preference is exceeded by their gaining a pro rata share of the combined liquidation preference of both the Series A and B, spread out over all outstanding Series A, Series B, and common shares. So long as the total amount expected to be distributed to stockholders in an eventual acquisition is more than the combined liquidation preferences of the Series A and B, the answer to this question is independent of the actual amount to be distributed. Instead, it depends only on the estimated amount raised in the Series B financing and the estimated pre-money valuation of that financing.

Applying this equation for our hypothetical company above, we can see that if the Series A investors anticipate that the company will need to raise approximately \$16 million in a Series B financing, they should propose participating preferred only if they think that the company will not be able to obtain a pre-money valuation in the Series B financing of the anticipated pre-money valuation of the

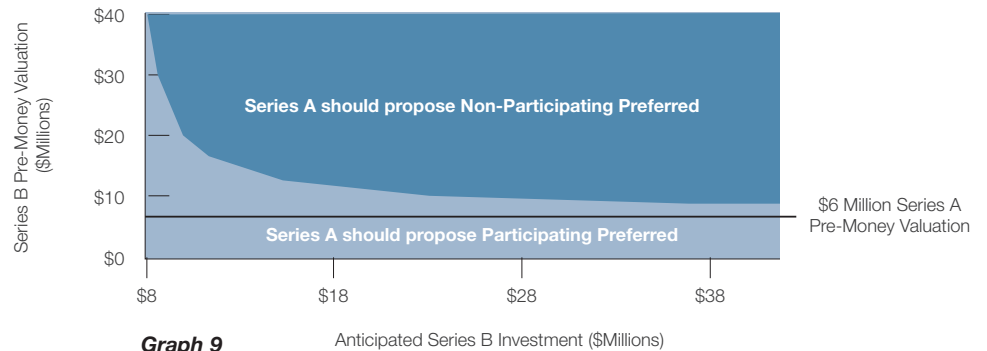
more than \$12.8 million (compared to the Series A post-money valuation of \$8 million).

More generally, the graph below shows the maximum Series B pre-money valuations for proposing participating preferred for a range of estimated Series B amounts raised. The graph demonstrates that in almost all realistic anticipated Series B scenarios, the Series A will do better with non-participating preferred. Participating preferred will be better only when (a)

company is not seen as having sufficient growth possibilities to make good use of more invested capital. In short, for any subsequent financing that an earlier investor would generally hope for—a large financing round (or series of rounds) or a significantly higher pre-money valuation, or preferably both—the choice is clear.

We started this article noting the marked shift from participating to non-participating preferred stock in recent years. Perhaps this shift, along with higher pre-money valuations generally, is merely part of a current trend of more

Maximum Series B Pre-Money Valuation for Proposing Series A Participating Preferred



Graph 9

Series B financing is very close to the post-money valuation of the Series A financing, which likely indicates that the company is expected to make little progress between the two rounds, or (b) the anticipated amount to be raised in the Series B financing is not much more than the pre-money valuation of the Series A financing, possibly reflecting an expectation that the company will be very cash-efficient, but more likely that the founder-favorable first-round investment

terms. But the underlying numbers show that whether Series A investors know it or not when they propose non-participating preferred, doing so is very much in the financial interest of not only the founders, but also of the Series A investors themselves.

The derivation of the formulas used above, conceptual explanations, and additional comments may be found at <https://www.wsqr.com/PDFs/ER-0515.pdf>.

Haves and Have Nots in Venture Financings

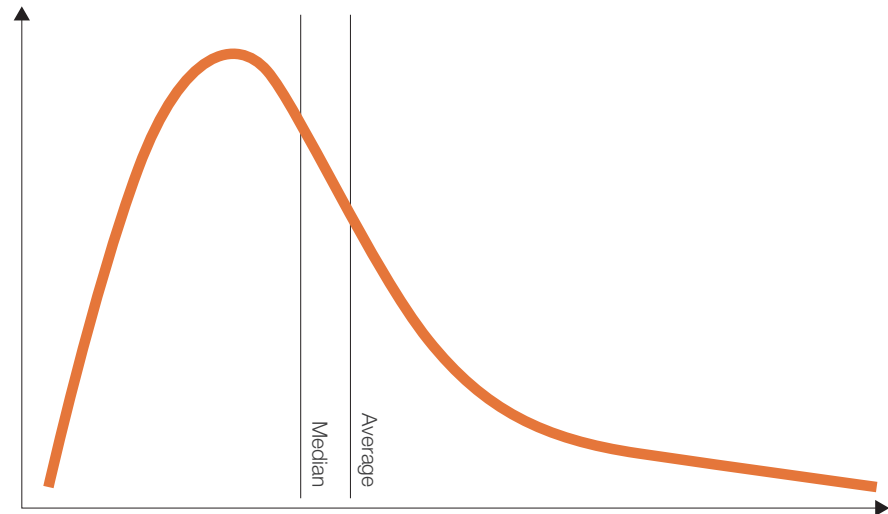
Data from Wilson Sonsini Goodrich & Rosati shows that a small number of companies always command the highest valuations—now and five years ago

*By Eric Ver Ploeg, Managing Member,
Recursive Capital*

Various commenters have recently observed that there appears to be a small number of very hot start-ups that can easily raise large amounts of capital at very high valuations, and a larger number of not-as-hot start-ups that face more difficulty in raising money. Representatives from Wilson Sonsini Goodrich & Rosati were kind enough to share some population statistics drawn from their financings database in response to discussions from my previous article ("[‘VC Bubble’ a Reflection of Public Markets](#)"). More specifically, we wanted to see if that data supported the notion that venture financings have dichotomized into a world of Haves and Have Nots. If the data showed average valuations were climbing faster than median valuations, that would be consistent with an increasing dichotomization.

Positive Skew Distribution

Since the lowest valuation in a venture financing can't go below zero and the highest valuation is unbounded, we expect the average to be higher than the



Generic positive skew distribution example

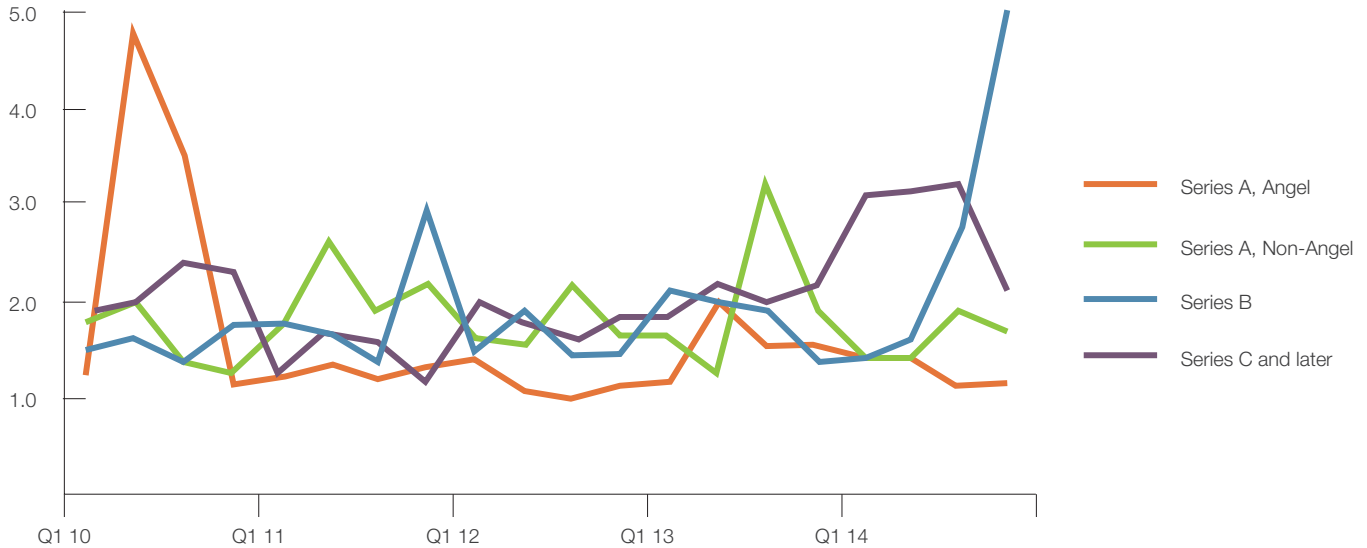
median. Above is a graphical reminder of what a positive skew distribution looks like.

The ratio of the average value to the median value gives us a measure of how far out those outliers on the right-hand side are. The higher this ratio, the more pronounced the Haves vs. Have Nots separation is. And, if the Haves vs. Have Nots issue was becoming more pronounced over time, we would expect this ratio of average valuation to median valuation to go up over time. On the next page is a plot of those ratios drawn from the WSGR financings universe. Each point in this plot represents the average pre-money valuation of the financings WSGR was involved in for the given quarter and the given financing sequence, divided by the median pre-money valuation for the same group.

Higher ratio indicates more pronounced positive skew — a few high-value outliers. As expected, we see the ratios are generally well above 1.0. The average ratio across all 80 quarterly data points is about 1.9, which indicates a very pronounced positive skew to the population. This says that venture financings generally have a small number of hot companies commanding very high valuations and a larger number of less-hot companies getting significantly lower valuations.

Looking at the data over time, it's hard to draw any strong conclusions. We humans are given to seeing trends where there is just statistical noise. The apparent trend of rising Series B dichotomization over the last few quarters may be evidence of an increasing dichotomization

Ratio of Average Pre-Money to Median Pre-Money, by Stage (WSGR Financings)



Ratio of average to median pre-money valuations in WSGR financings universe

between the Haves and the Have Nots, or it may just be statistical noise. The fact that the Series C+ financings don't show this behavior makes it harder to believe there is a truly causal increasing Haves vs. Have Nots effect.

Finally, in the table to the right, we see something that does seem statistically significant for this data set: The Haves vs. Have Nots effect increases with the financing stage sequence, which doesn't seem too surprising. When an Uber is raising Angel money, it is just another intriguing start-up story, and it commands less of a premium relative to all other financings. But, when they are raising a \$1.2B Series D, they have the staggering financial metrics to prove they are the hottest company around.

| Ratio of Average Pre-Money to Median Pre-Money, by Stage for the last 20 Quarters (WSGR Financings) | | | | |
|---|-----------------|---------------------|----------|--------------------|
| | Series A, Angel | Series A, non-Angel | Series B | Series C and Later |
| Average | 1.60 | 1.83 | 1.95 | 2.07 |
| Standard Deviation | 0.92 | 0.49 | 0.86 | 0.56 |
| Standard Error | 0.21 | 0.11 | 0.19 | 0.13 |

Summary statistics from plot above

In summary, this data leads us to three interesting conclusions:

1. Venture financings have always been about Haves and Have Nots, with average pre-money valuations for the few hot companies far outstripping the valuations of the large number of less-hot companies.
2. The Haves vs. Have Nots effect is more pronounced with later

sequences of financings, with a high degree of statistical certainty.

3. There is only weak statistical support for the idea that the Haves vs. Have Nots effect has increased over the last 20 quarters.

Eric Ver Ploeg is a managing member at Recursive Capital. He previously spent 10 years as a venture investor and five years as the co-founder of two venture-backed start-ups.

Methodology for WSGR's Entrepreneurs Report

- The Up/Down/Flat analysis is based on WSGR deals having an initial closing in the period reported to ensure that the data clearly reflects current trends.
- The median pre-money valuation is calculated based on the pre-money valuation given at the time of the initial closing of the round. If the issuer has a closing in a subsequent quarter, the original pre-money valuation is used in the calculation of the median for that quarter as well.
- A substantial percentage of deals have multiple closings that span fiscal quarters. The median amount raised is calculated based on the aggregate amount raised in the reported quarter.



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For more information on the current venture capital climate, please contact any member of Wilson Sonsini Goodrich & Rosati's entrepreneurial services team. To learn more about WSGR's full suite of services for entrepreneurs and early-stage companies, please visit the Entrepreneurial Services section of wsgr.com.

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