

What Are the Terms? -Part 1 A Preferred Return

This is a Reprint from the Monthly Column in **Boston Business Journal**

STARTING UP: *Practical Advice for Entrepreneurs*

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Several entrepreneurs and private investors have asked me to do a *Starting Up* column on "nonprice" investment terms. Many entrepreneurs I know have gone into at least a mild panic when they see the typical 5-page termsheet. They have become somewhat paranoid and have started envisioning thousands of hidden traps in all of the financial and legal verbiage. They usually have re-entered a form of reality after I explain what the terms mean and what the investor is trying to accomplish.

I like to group the terms of a typical professional venture capital termsheet into four broad categories rather than tackle the terms one by one. Entrepreneurs have told me that this categorization has helped them see the big picture as they try to fathom the complexities of the deal. These categories are: (1) A Preferred Return, (2) Protection of Valuation and Position re Future Money, (3) Management of the Investment and (4) Exit Strategies.

A Preferred Return. Investors usually feel that their payment of cash is more "tangible" than the entrepreneur's promises of greatness. As a result, rightly or wrongly, Investors, especially venture capital investors, want their return to come before that of the entrepreneur. Although there are variations among venture fund groups based on tax and institutional issues, the typical investment instrument is convertible preferred stock.

Dividends. The holder of a preferred stock is entitled to receive dividends before dividends are paid on the common stock. This might not seem to be an issue with a high growth non-dividend paying entrepreneurial company. However, dividends do come into play if they are cumulative. In many preferred stock instruments, if the company can't or doesn't pay a dividend then the amount of the stated dividend accumulates and has to be paid in full before dividends can be paid on the common stock. Again, you might say this doesn't matter for a non-dividend paying company. But let's consider how cumulative dividends apply in liquidation.

Liquidation Preference. If the company is liquidated, the holders of the preferred are entitled to receive their investment back before the holders of any "junior stock" such as common stock receive anything. Here "investment" means the amount paid for the preferred plus any accrued and unpaid dividends. If the dividends are cumulative, then the amount which has to be repaid to the holders of the preferred stock grows every year. Fortunately for the entrepreneur, dividends do not "compound" like interest.

Downside and Upside. The liquidation preference provides some downside protection for the investor by giving the preferred holder the first money out of the company. However, depending on the "flavor" of the preferred the preference may also increase the investors "upside".

The most favorable from the entrepreneur's viewpoint is a straight convertible preferred in which the investor is put to a choice upon the occurrence of a liquidation event (usually defined to include a sale or merger in addition to a true liquidation/going out of business): either take your liquidation preference or convert into common.

In recent years the "participating preferred" has become more popular with investors. Here the holder of the preferred first gets the liquidation preference and then participates with the common as if he had converted. This "double dip" preferred can act to deprive the entrepreneur of a good portion of value if the company is not a home run success. For example, assume \$2 million is invested in exchange for a preferred which converts into 50% of the common. If the company is sold for \$5m the participating preferred holder would receive his \$2m initial investment plus 50% of the remaining \$3m, for a total of \$3.5m. In a straight convertible the investor would decide to convert into common and take 50% of \$5m or \$2.5m instead of taking his \$2m liquidation preference. This \$1m difference between the participating and straight preferred represents a fairly large percentage of a deal of this size. If the participating preferred also has a cumulative dividend then the effect is even larger. In our example, if the cumulative dividend is 10% and the company is sold after 5 years then the participating preferred would receive \$4m (80% of the deal).

Multiple Payout Instruments. In recent years in situations which are perceived to be more risky I have seen more use of preferreds or notes with multiple payouts. Here the investor receives a liquidation preference which is a multiple (e.g. 2 to 3 times) the investment. However, these can backfire in a manner similar to a high jump in which the bar is set so high that the jumper doesn't even really try. In one recent situation it became clear that the value of the company was not large enough to provide any meaningful return to management and after much hand wringing the investors waived the multiple preference so that management had some incentive to work to sell the company.

Morale: Focusing on what is an appropriate Preferred Return under various business scenarios should help the entrepreneur and investor slash through the detailed terms which implement concept.

Next time: Protection of Valuation, Management of the Investment and Exit Strategies.

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