
The Terms Behind the Unicorn Valuations

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Background

There has been much discussion about the high valuations of venture backed companies, and especially the “unicorns”, companies with a valuation of a billion dollars or higher. However, as the investors in these companies generally receive preferred stock, rather than the common stock that is issued in IPOs and held by public company investors, unicorn valuations are not directly comparable to public company valuations.

To better understand unicorn valuations we analyzed the terms of 37 US based venture backed companies that raised money at valuations of \$1 billion or more in the 12 month period ending March 31, 2015.

The average valuation of the companies we analyzed was \$4.4 billion, the median valuation was \$1.6 billion, the average percentage increase per share from the prior financing round was 180%, and the median percentage increase per share from the prior financing round was 100%. Of these financings, approximately 25% were led by traditional VC investors and approximately 75% were led by investors who were not traditional VCs (e.g., mutual funds, hedge funds, sovereign wealth or corporate investors).

Overview of Results

The highlights of our results are as follows:

- Investors received terms that provided a fair amount of downside protection for their investment, especially in the event of an acquisition, but relatively few upside benefits.
- These terms could result in a divergence in interest between early and late stage investors at the time of a liquidity event.
- A significant percentage of the highest valuation unicorns had dual class common stock which provided founders/management and in some cases other shareholders with super voting rights.
- Attaining a unicorn valuation appears to be a goal of promising companies raising money, as 35% of the companies we analyzed had valuations in the \$1-1.1 billion dollar range, indicating that the companies may have negotiated specifically to attain the unicorn level.

Survey Results

▪ Downside Protections

There are various different preferred stock terms that investors can use to protect their investment in the event the company's value declines. These terms include:

- liquidation preferences (which require that an investor receives its investment back prior to common investors receiving any proceeds, and if the investor has a senior liquidation preference, it receives its investment back not only before common investors, but also before other series of preferred stock);

- IPO conversion provisions (which provide, among other things, that an investor's preferred stock will only convert to common stock in an IPO, if the IPO is at a certain valuation, usually at least what the investor paid, or providing that if the IPO is at less than a certain valuation, the investor gets additional shares). Note that the conversion of outstanding preferred stock into common stock is basically a requirement to go public; and
- anti-dilution adjustments (which retroactively reduce the price of the stock an investor purchased if the company raises funds in a non-IPO future financing at a lower price).

Our analysis showed that the forgoing terms were used in the following percentage of unicorn financings:

Acquisition Protection Terms

Liquidation protection over common stock – 100%

Senior liquidation protection over other series of preferred stock - 19%

IPO Protection Terms

Minimum IPO price must be no less than unicorn round investment price – 16%

Payment of additional shares if IPO price below unicorn round investment price – 14%

Future Financing Protection Terms

Weighted average – 100%

Ratchet – 0%

***** Analysis:** Investors in unicorn financings have significantly more downside protection than public company common stock investors. These protections are especially strong in the event of an acquisition. For example, CB Insights reported that the 10 highest valued unicorns had an aggregate valuation of \$122 billion and an aggregate invested capital of \$12 billion. Since 100% of the unicorn financings had a liquidation preference, valuations of these companies could fall on average by 90% before the unicorn investors would suffer a loss of their investment, and they could withstand an even greater decline if they had a senior liquidation preference over other series of preferred stock.

IPO protections for investors were less strong. This is probably in part because investors assume that an IPO transaction in and of itself is an indication that a company is doing well, although a unicorn company could be doing well but still go public at a price per share less than the price paid by the unicorn investor. Approximately 30% of unicorn investors had significant protection against a down round IPO.

Future financing protection was present in the form of weighted average anti dilution protection in all rounds. This provides some, but very limited, protection.

▪ **Upside Benefits**

There are also various terms that unicorn investors can use to enhance their upside potential in a company. These provisions include:

- cumulative dividends
- liquidation participation (which provides that after an investor receives its money back in an acquisition, the investor then gets to participate with common shareholders in receiving the remaining proceeds).

- multiple liquidation preference (which provides that an investor gets more than its initial investment back before common shareholders (or possibly other preferred shareholders) receive any funds in a liquidation).
- IPO auto conversion threshold that is above the price paid by the investor, which assures the unicorn investor a profit on an IPO

Our analysis showed that these terms were infrequently used, as follows:

Cumulative dividends – 0%

Participating preferred – 5%

Multiple liquidation preference – 3%

IPO auto convert above per share price paid by investor – 11%

*****Analysis:** A result of the significant downside protections and relatively limited upside benefits provided to unicorn investors is that there could be a large range of valuations at which a unicorn could exit, especially by acquisition, in which the unicorn investor would be indifferent because it will not affect its return. For example, if an investor invested in a unicorn at a post money valuation of \$10 billion and the company had \$1 billion of total investment after such investment, and the investor had the typical non-participating liquidation preference, then the investor would be indifferent if the company was sold at any valuation between \$1 billion and \$10 billion. This could result in the investor having different strategic interests than investors who have invested at lower valuations. For example the founders and early investors might welcome an opportunity to sell the company at \$8 billion, but in that case the unicorn investor might prefer that the company not sell, but rather try to build more value above \$10 billion, so that the unicorn investor makes a gain on its investment.

This difference of interests is not unusual in venture capital, but the range of values at which late stage investors are indifferent is much larger than in the past when overall valuations were lower. One way to address this situation is to let founders/management/early investors sell some shares in a secondary transaction to reduce their interest in an early exit. But in most cases, if there is a difference of interest on when to sell the company, the founders/management and early investors will have the voting power to prevail.

- **Super Voting Stock**

22% of unicorn companies had a dual class common stock structure, which provided for one class of common stock to have significantly more voting power than the other class of common stock.

Of these companies, 37.5% provided super voting common only to founders and/or management, 25% provided such common stock to founders/management and early stage investors, and 37.5% provided such common stock to all pre IPO investors.

The companies that had dual class common stock structures were concentrated at higher unicorn valuations, with 70% of the top 10 highest valuations having such structure.

***** Analysis:** The concentration of dual class super voting common stock provisions in the highest valuation unicorn financings likely reflects the expectation that these companies are most likely to go public, that insiders have a desire to maintain significant voting control after the IPO, and that these companies have the negotiating leverage to obtain these provisions.

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