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Public-Private Gulf Puts Startup Valuations In The Spotlight

By **Elise Hansen**

Law360 (February 14, 2020, 6:24 PM EST) -- Startup valuations are increasingly in the spotlight, but the path from seed funding to unicorn to initial public offering can still appear opaque. Here, attorneys pull back the curtain on how valuation negotiations unfold — and why public market valuations don't always line up.

Casper Sleep Inc. raised a heady $100 million at a $1.1 billion valuation in March 2019 from big-name investors like New Enterprise Associates and Norwest Venture Partners and retailer Target Corp. When the mattress seller went public in early February, its IPO valuation was less than $500 million.

Casper joins a number of buzzy private companies that have experienced a so-called haircut, referring to a cut in valuation, as they went public. Uber and Lyft shares, for example, both traded well below their IPO prices for much of 2019, and coworking giant WeWork never made it across the finish line, instead yanking its IPO plans as the company's valuation plummeted from a private valuation of $47 billion to less than half that amount.

"Valuations are just moments in time," Casper CEO Philip Krim told CNBC the day after the company's public debut.

Representatives for Casper did not respond to requests for comment from Law360.

Krim's rather esoteric statement may sound more like the bedtime riddles from Casper's marketing campaigns. But while many companies have fared well in the transition to public markets, there are a number of reasons a startup can find itself in the barber's chair. On the one hand, there are factors that can affect any company, such as economic conditions or a major competitor entering the space.

On the other hand, private investments are structured differently from buying a public company's stock. When startups announce their latest valuation — usually without much explanation to the public — the seemingly simple price tag doesn't always reveal the underlying complexities.

The Negotiating Table

Fundamentally, a company's valuation is what percentage of the company a backer will receive in exchange for their investment. Many factors can weigh into the valuation balance, such as the perceived quality of a startup's management team, its financial metrics or product development milestones, said

Mark Leahy, co-chair of Fenwick & West LLP's startup and venture capital practice. The level of investor excitement around a certain industry can also play a role, Leahy said.

"Sometimes certain sectors have a lot of investor enthusiasm, and investors experience some FOMO — fear of missing out," Leahy said. "There may be a little of that that drives up valuations of companies in those spaces."

The bang for the investor's buck is just one of many negotiations that takes place during a financing round. A model term sheet from the National Venture Capital Association contains roughly 30 different terms that frequently feature in discussions, from whether an investor will gain a board seat to lock-up provisions to liquidation preferences.

The number of terms involved complicates the valuation calculus. Unlike public company stock, which is typically common stock, venture capitalists are often buying preferred shares, which can come with provisions designed to protect investor funds.

Casper, for example, promised its Series D investors a higher conversion rate from preferred stock to common stock if the IPO price fell below the Series D price per share of $31.24715, U.S. Securities and Exchange Commission filings show. Series C and Series B investors were given similar protections, the disclosures show.

Preferred investors also often get liquidation preferences, which promise they'll receive a certain amount of their money back before holders of common stock if the company is sold or goes bankrupt, Leahy said. And sometimes, often in later rounds, investors will seek seniority for their payout, ensuring they'll be paid back before other preferred investors.

Senior liquidation preferences in 2018 and 2019 appeared in roughly 25% of financings studied in a Fenwick & West report published Tuesday. The report examines a sample of emerging companies headquartered in the Silicon Valley area.

While provisions like these help protect venture capital firms from the downsides of their investments, they don't guarantee additional returns -- which is generally what venture capital firms are going for, Leahy noted.

"VCs are in it to do more than just gain back their money. They could just stick it in the bank for that," he said.

But some provisions can ratchet up investor returns. While rare, cumulative dividend provisions promise that backers will get back the amount of their liquidation preference, plus an additional return, before anything is paid on the common stock. And with participation rights, preferred investors get their liquidation preference amount back and then share leftover returns with common-stock investors, Leahy said.

Murky Waters

These terms can help make a company's preferred stock more valuable than its common stock. But the public messaging around startups' fundraising doesn't always grapple with the complexities.

Many startups announce a post-money valuation after a financing round. That can indicate the worth of

the stock in the latest round and at the most recent set of investor terms, but can be over-broad if extrapolated out to the whole company, according to a 2017 study from Stanford University's Graduate School of Business.

"Reported valuations assume that all shares are as valuable as the most recently issued preferred shares," the study notes.

But because the investment terms can change with each funding round, not all preferred shares will be equally valuable — not to mention common stock, the study said.

The researchers developed a formula to try to model the added value of various investment terms, then used those numbers to determine the value of the common stock. The study looks at 135 U.S.-based "unicorns," or venture-backed companies with a reported valuation above $1 billion.

By their calculations, common shares without protections were 56% overvalued by post-money valuations.

"Some unicorns have made such generous promises to their preferred shareholders that their common shares are nearly worthless," the researchers said in an early version of the study.

Attorneys can play a key supporting role in this drama, Will Gornall, one of the study's co-authors, told Law360. Gornall is an assistant professor of finance at the University of British Columbia.

"I think to the extent attorneys can help contextualize and both remind founders what is and what isn't the market standard, and help them understand how these terms are shifting value away from them, then that can be adding a lot of value," Gornall said.

Particularly when working with early-stage companies or first-time entrepreneurs, attorneys can help clients think through the implications of the contractual terms and help them prep for valuation discussions, said Ori Solomon, co-chair of Morrison & Foerster LLP's emerging companies and venture capital practice.

"You're well served to really question why they believe the valuation they should be getting," Solomon said. "I think it's important to have a well thought out argument as to why the valuation you are looking for makes sense."

Different Priorities

All those factors can make a startup's valuation look rosier in the private markets than in public markets. But sometimes, private and public investors just care about different things.

Public investors have started shifting their emphasis toward profitability and corporate governance, a trend that's likely to continue in 2020, said Frank Lopez, co-head of the global securities and capital markets practice at Paul Hastings LLP.

"It's very different than the dichotomy we saw for many years, where public markets seemed, in a sense, to be easier money and a higher valuation," Lopez said. "Particularly in the last year, you're seeing almost more of a discipline in the public markets."

But those concerns don't have to transfer to private markets, Solomon noted.

"Sometimes when you invest in private companies that are years away from profitability, you're valuing them on other metrics," Solomon said. As the companies grow and consider going public, the focus can increasingly turn to profitability.

"Those two different valuation methodologies don't always line up with each other," Solomon said.

Leahy echoed that sentiment, adding that occasionally the growth route does pay off in spite of public investor skepticism.

"VCs often invest in growth, rather than profitability. You come to the public markets where they're a little more focused on profitability, and so that perhaps pushes down the valuation," Leahy said.

"But think of Amazon: They weren't profitable for a while. They grew like crazy and then they figured out their profitability metrics," he said. "Maybe the growth story was the right answer."

And VCs' chase for the next big win could keep private money flowing for some time, Gornall said.

"People are still investing in startups with the hope that they will become a Facebook or a Google, Microsoft or Amazon," Gornall said. "At least presently, we seem to be at a relatively exuberant point in the cycle."

--Additional reporting by Tom Zanki. Editing by Breda Lund.
