Private Equity – Valuation enhanced by Liquidation Preferences and Anti-Dilution Clauses

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Prof. Dr. Dirk Honold
Georg-Simon-Ohm-University of Applied Sciences
Nuremberg, Germany

Abstract:
Private Equity and especially Venture Capital is usually invested under high risk. Young, innovative companies usually do not have a track record and approach emerging markets with losses for the next couple of years. As a result, forecasts of future cash-flows are less good. In addition, agency problems between the investor and management incl. founders are more critical.

Usually shareholders participate from results and a sale of the company (exit) according to the individual stake of the shareholder which results from a negotiated valuation. Special cash-flow rights like liquidation preferences and anti-dilution clauses allow the investor to align the interest of the parties better and to re-allocate cash-flows in addition to the pro-rata distribution. Generally, these rights increase the return of the investor under certain circumstances or scenarios, e.g.
- anti-dilution clauses improve the cash-flows in the case of a later down round or
- liquidation preferences can even lead to a general higher return due to a possible double dipping.

Using these rights the balanced contract between founders and investors is more complex and there is a pay-off between these rights and the valuation of the company. Rationale negotiations need a clear valuation of these rights by financial managers and tactics apply which both will be discussed in the presentation.

Presenter: Prof. Dr. Dirk Honald