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IN MERGERS AND ACQUISITIONS, YOU NEED TO KNOW WHERE THE WATER FALLS

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Although the group TLC may have made millions singing "don't go chasing waterfalls," such advice can cost you dearly in mergers and acquisitions.

You see, few deals are straight cash at close.

This is particularly the case in many venture capital or private equity sponsored investments where the seller retains stock right along with the buyer.

But here's the rub.

At first glance, sellers may think they're riding right along with the buyer, when in fact, they can be trailing far, far behind.

You see, it is not at all uncommon for buyers and sellers to receive different classes of stock – preferred or common – that are treated quite differently upon exit.

For example, we often see buyers receiving shares that have so-called "liquidation preferences." For instance, if an investor has a 2x liquidation preference, upon exit they receive twice their initial investment before any proceeds are distributed to common shareholders.

Alternatively, investors may receive "non-participating" preferred shares that earn a fixed rate of interest that can, at the buyer's discretion, convert to non-interest-bearing common shares – the class typically allocated to sellers.

By doing so, if the company tanks, preferred shareholders don't convert and upon sale, they are first in line to cash out their shares plus accrued interest, leaving common shareholders with whatever is left over.

It gets really interesting when the shares are of the "participating" variety. In this case, preferred shareholders first receive the value of the shares plus accrued interest, but then they also "participate" in the distribution of the remaining proceeds along side of the holders of common stock.

Talk about having your stake and getting it too.

Add lenders who may have rights to convert debt to equity, well, you might begin to think it's possible that even in a successful exit, there may not be much left over for the commoners after everyone at the head of the class takes their cut.

And you would be right.

In fact, such appears to be the case when the online sports fantasy site FanDuel was recently acquired by Paddy Power Betfair.

According to technology news website Recode, despite commanding a cool $465 million, Nigel Eccles, the founder of the company who stepped down as CEO six months before the deal "…didn't make a dime on the deal thanks to a 'waterfall' financial arrangement in which some of the company's early investors were paid out first. FanDuel's $465 million valuation wasn't large enough that people who owned non-preferred shares – mostly regular employees including founders – actually made any money."

Now in this case, Eccles didn't make the call on the transaction, and there were a variety of complicated circumstances that may have contributed to the outcome, but you get the point.

One more thing.

There's no mergers and acquisitions handbook that says that deals must be structured this way.

But when they are, know that one party (typically the buyer) is bearing less transaction risk than others (typically the seller).

And this ***should*** (and we emphasize should) have implications on valuation. Quite simply, on a ***comparative*** basis, a buyer should *(and there's that word should again)* pay more for the rights to a preferred position in the waterfall.

So if you think your company is worth $25 million, and the buyer hits that mark (but does so by taking a 60% position in the company for $15M in preferred shares leaving you with $10M in common), it may still be a good deal.

But faster than you can say, "Holy shmagoli, I'm a millionaire," on paper their shares are worth more than $15M – and yours are worth less than $10M.

Now again, it doesn't mean that the deal isn't a good one. But it may be different than what you might have anticipated when you agreed to retain a 40% equity interest in the company.

All of which is just another reason why it is incumbent on sellers to ask buyers to model the waterfall of sale proceeds – both under favorable ***and*** unfavorable outcomes. That way (and perhaps only that way) can you really understand the interplay and implications of liquidation preferences, varying classes of stock, convertible debt, etc. (and how it all could alter your perception of a proposal's "real" value).

Because after the deal is done is not the time to go chasing waterfalls.

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