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Tech IPOs Triggering More 'Ratchets' In Shaky Market

By **Tom Zanki**

Law360, New York (January 27, 2016, 9:36 PM ET) -- A recent study shows that the percentage of initial public offerings in the technology sector that trigger so-called ratchet mechanisms, which lower the risks for late-stage investors, rose sharply in 2015, a trend attorneys expect to continue given worries about lofty private valuations and public market volatility.

In a report released Wednesday examining the effects of late-stage venture financing on IPOs, Silicon Valley law firm Fenwick & West LLP noted that the rate of technology offerings triggering ratchet mechanisms rose from 4 percent in 2014 to 50 percent in 2015.

	2014	2015	Combined 2014-2015
Percentage of IPOs in which a ratchet adjustment was triggered	4%	50%	20%
Average percentage of fully-diluted pre-IPO shares issued due to ratchet	1%	3%	3%

Source: Fenwick & West

Ratchets are negotiated agreements in which late-stage investors of a private company — also called crossover investors because they begin investing in a company shortly before it goes public — are assured additional shares if the IPO price falls below a specified level.

Attorneys say such agreements have become more common now that technology startups have achieved rich private valuations that some investors believe is not sustainable, especially given the weakened state of public markets.

“There is increased concern about the higher volatility of the market,” Fenwick & West partner Barry Kramer, the report’s co-author, said. “I think investors have made it a higher priority to negotiate for that.”

Kramer was quick to mention that the sample size of 2015 IPOs measured by Fenwick & West was only 14, much smaller than the 27 reported in the prior year, a trend that reflects the general softening of the IPO market. The firm analyzed U.S.-based technology IPOs in 2014 and 2015 that had undertaken venture financing in the prior three years before going public. Fenwick & West said total IPO ratchets triggered for both years combined was 20 percent of 41 IPOs.

Ratchets can be controversial because they dilute the outstanding shares of a company, giving those late-stage investors an advantage over the retail public or early-stage venture investors and company employees.

The Fenwick report indicates that ratchets diluted those companies' pre-IPO shares by an average of 3 percent. While no company wants to give away such a stake, Kramer said, it's not an amount that significantly changes a company's direction or capitalization structure.

"A ratchet is not something trivial for a company to give up," Kramer said. "It's part of a negotiation. I guess what this says is, at least so far, those companies that have given it up have not suffered severe results from it."

Square Inc. was among the technology IPOs that triggered ratchet clauses last year. The digital payments company said in its registration statement that certain late-stage investors, including underwriter J.P. Morgan, which bought its Series E shares valued at $15.46 in private funding round in fall 2014, would be awarded additional stock if a public offering valued Square shares at less than $18.56, essentially assuring those investors a 20 percent return.

The provision came in handy for those investors, as Square's IPO priced at $9 per share amid a cool market. Square gave the late-stage investors 10.3 million additional shares totaling $92.7 million, to compensate for the reduced IPO price, according to a regulatory filing. In the case of Square, 10.3 million shares of its total 322.9 million shares represented about 3 percent of the company's outstanding stock, consistent with the overall average in Fenwick & West report.

As institutional investors increasingly seek to protect themselves from downsides, ratchet clauses are likely to continue because private companies want to attract those very investors, according to Anna Pinedo, a Morrison & Foerster LLP partner.

"Having those institutional investors as shareholders is a very compelling proposition," Pinedo said. "They add a lot of credibility and luster to the company. There may be compelling business reasons why it makes sense to agree to such a ratchet."

The increase in ratchet provisions coincides with rising concern that valuations at private technology companies — including many of the so-called unicorns, or private companies valued at $1 billion or more — are disconnected from public reality. Fidelity Investments last November said it marked down the value of its investments in privately held technology startups like Dropbox and Snapchat, which are both considered unicorns, the latter by more than 25 percent.

Venture capital database CB Insights estimates there are now 144 so-called unicorns, many of which are staying private for longer durations than companies in the past. The technology industry last year produced its lowest output of IPOs since 2009.

Additional data from Fenwick & West's report shows signs of cooling enthusiasm for tech IPOs. The study indicates that 57 percent of the technology IPOs in 2015 were valued higher than their last venture round, down from 78 percent in 2015. For both years combined, 71 percent of IPOs were valued higher than their last venture round.

Going forward, Cooley LLP partner Charlie Kim said private companies that have ratchet provisions may wait for a better public environment before completing an IPO. If possible, companies would rather avoid dilution as well as the negative publicity associated with an IPO valued lower than its last private round.

"I think those are two of the factors that some of the private companies who have sold shares at high valuations to investors with ratchets are thinking about as part of their analysis in deciding whether to go public or not right now," Kim said. "But others are more focused on when is the right time for their business to go public and how their stock will perform for years post-IPO.”

--Editing by Jeremy Barker and Philip Shea.
