

### STRUCTURED PREFERRED STOCK

In today's economic climate, management teams face complex challenges that require them to balance higher operating costs, potential reductions in business key performance indicators, compressed market multiples, and the need for capital infusions to support their intended growth trajectory. Even successful businesses may need to raise capital at a lower price per share than prior rounds, commonly called a down-round. Down-rounds present several challenges, such as diluting existing shareholders and triggering anti-dilutive provisions in other classes of instruments that ratchet down participation thresholds to the price per share of the latest equity financing round. Consequently, management teams are keen to secure financing to operate and grow their businesses while avoiding the pitfalls of down-round equity financing.

Many of our private company clients have turned to structured preferred stocks to overcome the challenges associated with down-round equity financing. These instruments allow for a specified liquidation preference at issuance, but the conversion price is contingent upon a future capital raise. In particular, investors can convert the preferred stock at a discount to the issuance price of the next round of equity financing if and when it occurs. This feature gives investors incremental equity returns compared to an identical preferred stock instrument with a fixed conversion price, especially if equity prices continue to decrease, without the need to issue the preferred stock at a lower price. Private companies can set a higher fixed conversion price by providing downside protection, relinquishing less equity if equity values increase, and avoiding triggering down-round provisions in other instruments. These instruments enable private companies to raise equity capital while avoiding triggering some risks associated with a down-round.

*"Applicable Conversion Price" shall mean ..., in the case of the Series [ ] Preferred Stock, a per-share amount initially equal to, for the purposes of determining the number of shares of Common Stock into which each share of Series [ ] Preferred Stock is convertible in a Qualified Liquidity Event, the lesser of (A) 80.0% of the Qualified Liquidity Event Price and (B) \$100.00..."*

To illustrate the benefits of this discount conversion feature, consider the prices of the next financing round, the future qualified financing price, as shown in the table below. For prices at or below the initial investment amount, there is a fixed payout producing a 1.25x multiple of invested capital, corresponding to the initial investment of \$100 per share divided by the 80% discount. Due to the discounted conversion price, as the common stock price decreases further, the conversion price will also decrease, giving the preferred stockholder more common shares while maintaining a fixed return of \$125 per share of preferred stock. However, upside equity participation is retained for future qualified financing prices greater than \$125. If the common stock price in the next round is \$150 per share or higher, the conversion price of the preferred stock will be capped at \$100 per share, and the conversion will happen on a one-to-one basis, similar to traditional, fixed-conversion preferred stock.

		Downside Case			Initial Investment	Upside Case		
<b>Future Qualified Financing Price</b>	\$25	\$50	\$75	\$100	\$125	\$150	\$175	
<b>Discounted Conversion Price</b>	\$20	\$40	\$60	\$80	\$100	\$100	\$100	
<b>Conversion Ratio</b>	5.00	2.50	1.67	1.25	1.00	1.00	1.00	
<b>Structured Preferred Payout</b>	\$125	\$125	\$125	\$125	\$125	\$150	\$175	

## ACCOUNTING AND TAX CONSIDERATIONS

The example above provides a simplified illustration of structured financings. However, such transactions' financial and tax implications can be complex, as they can create an instrument with debt and equity characteristics. This complexity drives an interrelated set of accounting, valuation, and tax issues, including:

1. Appropriate balance sheet classification: The preferred stock may require classification as a liability or mezzanine equity rather than permanent equity. The highly customized nature of these instruments makes this determination challenging.

*Balance Sheet Classification: Does the preferred stock represent a future obligation of the company?*

	Measurement Basis	Financial Statement Effects
<b>Liability</b>	<ul style="list-style-type: none"> <li>• Current Fair Value</li> </ul>	<ul style="list-style-type: none"> <li>• Each period, any change in fair value will flow through the income statement as profit or loss</li> </ul>
<b>Mezzanine Equity</b>	<ul style="list-style-type: none"> <li>• Redemption Value</li> </ul>	<ul style="list-style-type: none"> <li>• Each period, any change in redemption value will be treated as a deemed dividend with a direct reduction to retained earnings</li> </ul>
<b>Equity</b>	<ul style="list-style-type: none"> <li>• Issuance Date Fair Value</li> </ul>	<ul style="list-style-type: none"> <li>• No remeasurement required</li> </ul>

2. Identification of embedded features: Conversion, redemption, and dividend provisions must be assessed to determine whether they require separate accounting as derivatives. Other bespoke terms may also require bifurcation.

*Nature of the Preferred Stock: Does the preferred stock provide rights and returns more like an equity investment or more like a debt investment?*

	Potential Bifurcated Features	Financial Statement Effects
<b>Equity-Like</b>	<ul style="list-style-type: none"> <li>• Puts or other redemptions</li> <li>• Dividends at default rates</li> <li>• Escalating dividends</li> </ul>	<ul style="list-style-type: none"> <li>• Bifurcated features are recognized at their issuance date fair value, usually as liabilities</li> </ul>
<b>Debt-Like</b>	<ul style="list-style-type: none"> <li>• Conversion features</li> <li>• Redemptions at a significant premium</li> <li>• Escalating dividends</li> </ul>	<ul style="list-style-type: none"> <li>• Each period changes in fair value flow through the income statement as other profit or loss</li> </ul>

3. Valuation of bifurcated derivatives: Features that are accounted separately must be valued at issuance and then marked to market at each financial reporting period.
4. Debt versus equity classification for tax purposes: The form of issuance as equity or debt is not binding on tax authorities. It may be scrutinized and, in certain circumstances, recharacterized for tax purposes. This may impact the tax treatment of the go-forward proceeds on the preferred security for both the issuer and holder and the issuer's ability to deduct payments made on the instrument. Such consequences will vary depending on the tax classification and residence of the issuer and the holder and the specific terms of the structured preferred stock.

	Equity Classification	Debt Classification
<b>Issuer Deductions</b>	<ul style="list-style-type: none"> <li>Distributions on equity are generally nondeductible</li> </ul>	<ul style="list-style-type: none"> <li>Interest on debt is generally deductible subject to limitations that can vary based on such factors as profitability, debt-to-equity ratio, or purpose of the borrowed funds</li> </ul>
<b>Treatment of Proceeds</b>	<ul style="list-style-type: none"> <li>If a U.S. corporate issuer, the holder may be eligible for dividends-received deduction; if a foreign issuer, a participation exemption may apply</li> <li>If a qualified dividend, U.S. individuals may benefit from lower capital gains rates</li> <li>Foreign holders may be subject to a 30% withholding on dividends</li> </ul>	<ul style="list-style-type: none"> <li>Distributions (including PIK) are generally treated as interest on debt and taxed on a current basis at ordinary rates for U.S. holders</li> <li>Foreign holders may be subject to 30% withholding unless eligible for portfolio interest exemption</li> </ul>
<b>Other Considerations</b>	<ul style="list-style-type: none"> <li>Certain preferred equity instruments may create "phantom" income for the holder</li> </ul>	<ul style="list-style-type: none"> <li>Certain preferred equity instruments treated as debt may create "phantom" income for the holder</li> </ul>

## HOW HOULIHAN LOKEY CAN HELP

Houlihan Lokey can help you structure your preferred equity financing to avoid unwanted outcomes, assess the instrument's classification, identify bifurcated derivatives, document the accounting judgments and conclusions, and address issuance date and ongoing valuation needs. Our team of accounting and financial instruments specialists has deep experience helping clients navigate complex financial structures and address management planning, financial, and tax reporting issues.

Houlihan Lokey's transaction expertise and leadership in the field of valuation inspire confidence in the financial executives, boards of directors, special committees, investors, and business owners we serve. We focus on our clients, addressing their financial and business needs quickly and efficiently. We support private equity sponsors and private-equity-backed management teams as they optimize portfolio company operations. Our cross-functional teams of technical accounting, quantitative finance, corporate valuation, and tax experts can help you navigate the challenges presented by complex reporting requirements and heightened regulatory scrutiny.

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