Venture Capital Transactions In The United States And China

Fred Tannenbaum, a co-managing partner at Chicago-based law firm Gould & Ratner LLP, is widely recognized as a leading expert private equity and venture capital investments and as a leading authority on mergers and acquisitions. He has also been selected as an Illinois Super Lawyer. He has a wide range of experience in advising clients on sophisticated transactions and has published extensively on business and legal topics. Fred is also the Past President of LawExchange International, a network, together with Law Firm of the Americas, of 30 law firms in Europe, Australia, China, India, and South and North America.

Scott Guan, a co-managing partner at Shanghai-based law firm Jade & Fountain PRC Lawyers, has extensive experience in cross- border mergers and acquisitions, private equity and venture investments, capital markets, foreign direct investment, corporate restructurings, dispute resolution, as well as general corporate and business advice. In addition to his practice, Scott has lectured and written on a number of topics in the commercial law area, and has published articles and two books on China's telecommunications regulation.

Fred Tannenbaum and Scott Guan

Venture capital investment is on the rise in China, and many of the operative concepts are the same as they are in the United States.

ALTHOUGH AT ITS early stage, venture capital ("VC") in China, as an increasingly important means of financing, is developing rapidly. Many international VC firms are active in the vast Chinese market and played an important role in financing Chinese startup companies and bringing them public in overseas stock markets. Success stories include the 2004 NASDAQ listing of Shanda Networking (a leading online game operator) raising $151.8 million and Suntech Power's 2006 NYSE IPO, raising $400 million for the solar power equipment manufacturer. In these transactions, international VC firms all made handsome profits.

According to a recent research report released by Zero2IPO Group based on its survey on the Chinese private equity market, 58 newly raised funds targeting Asia, including the Chinese mainland, collectively raised $3.25 billion (U.S.) during 2007. Of this amount, over one-half ($1.8 billion) originated from U.S. funds. The total funds raised in 2007 that were allocated to investments in China increased by 83 percent over 2006. One hundred and seventy Chinese enterprises received $2.49 billion from 105 private equity ("PE") funds in 440 reported deals. These statistics and data show that China is the most active PE market in Asia. Zero2IPO Research Center estimates that

PE investment on Chinese market accounts for 1.5 percent of the 2007 global total. During 2007, the most active investments were made in the broadband information technology sector (46 percent) and a very high (by U.S. standards) 17 percent in what were categorized as traditional businesses.

According to another survey by Zero2IPO Group, VC investment was strong in mainland China during the first quarter of 2008. Eighteen foreign and domestic firms established 23 new funds during this period, representing $2.26 billion of committed capital, an increase of 57 percent from the last quarter of 2007 and 537 percent the first quarter of 2007! During the first quarter of 2008, investors put $941 million into 116 deals with broadband information technology, again accounting for the bulk of deal activity and investment. This upward trend continued into the second quarter of 2008, as VC investments reached $1.20 billion, a 73.5 percent increase from the second quarter of 2007. Similarly, the second quarter's 159 investment deals represented a 31.4 percent increase from the second quarter of 2007. However, no mega ($100 million or above) deals took place in August of 2008. As compared to July, August saw both the number of investment deals (down 27.3 percent) and the amount invested (down 72.4 percent) decline.

It is fair to say that international VC firms, especially those from the United States, are playing a leading role in the evolution and development of the VC industry in China. International VC firms, before making investment in a project in China, usually require the Chinese company to undergo a restructuring, in which one or a series of offshore holding companies are set up for holding the interests in the ultimate operating company in China. In such transactions, international and local advisors are required to work together to help the investors and the founders to close the transactions, both onshore and offshore. In such transactions, U.S. law firms have been playing an important role and in fact have exported a lot of U.S. VC concepts, models, and practices to the Chinese market.

In this article, we will first discuss five major structural components in virtually every VC transaction, whether it is in North America, Europe, or Asia. We will then briefly investigate the underlying concerns of VC investors. We hope that this deconstruction of the significant structural and motivational underpinnings of this major source of finance will help facilitate cross-border investments, provide fertile ground for critical self-examination and improvement, and offer insights to those seeking VC financing to appeal to the needs of their future partners.

We have made our discussions and observations in the context of the U.S. VC transactions. But with the international VC practice becoming increasingly universal, we believe such discussions and observations will be of equal reference value to the VC community in China.

FIVE MAJOR STRUCTURAL COMPONENTS OF VENTURE CAPITAL FINANCING • The basic structure of most VC transactions is quite complex and interwoven, with each feature being dependent on the other. For purposes of this article, we have identified five key components (in no particular order) of the structure of a venture capital deal and briefly discuss their relevance and interrelationship.

1. Liquidation Preferences

In the United States, virtually all VC transactions are structured with liquidation preferences in favor of the investor. In other words, the investor will receive its investment back first, before any return to prior investors. For example, assume the target portfolio company is valued at $10 million before the investment and the venture capitalist invests $10 million for 50 percent of the equity. Then, unfortunately, the company is sold for only $10 million. The proceeds would all be distributed to the venture capitalist, and the other owners would get nothing. That is a vast generalization and oversimplification, however, and many refinements abound.

First, if there have been other rounds of VC financing, you will occasionally see the other VC investors in the prior rounds share in the distributions. Using the prior example, if there had been $10 million raised in the A round and then $10 million raised in the subsequent B round, and the hapless company were liquidated for $10 million, the B round investor would like to receive the entire $10 million. The A round investor, however, may have been able to negotiate pari passu treatment, and therefore, the $10 million would be distributed $5 million each to the A and B round investors.

A second significant consideration is whether the investment will participate or be directly convertible to common equity. The difference could be material and is often overlooked by less experienced founders. For example, assume the investor invests $10 million in the A round for 50 percent of the company on a fully diluted basis. This company is then ultimately liquidated for $40 million (much preferable to the prior examples). If the A round investment was a "participating preferred," then it would receive the first $10 million of proceeds. The remaining $30 million would be distributed on a 50-50 basis so that the investor would receive an additional $15 million and thereby receive a total of $25 million of the $40 million proceeds, which in this example equates to 60 percent of the total. Another way to look at the participating feature is to treat it like debt. You would always pay a lender back on liquidation before paying back equity owners. In contrast, if the A round equity were treated as "convertible preferred," then the investor would have the option to either receive its investment back (which it would only do if the sale price was less than $20 million) or convert to 50 percent of the common equity of the company. In this scenario, the investor would receive 50 percent of the $40 million liquidation price, which is $5 million less than the amount received in the case of a participating preferred investment.

A third area of debate in structuring preferences in VC transactions is whether the preference will be multiple. Although this is purely an economic valuation concept and a function of the leverage of the parties, the issue is hotly contested. For example, you will sometimes see the VC investor insist on a three-times liquidation preference. In the example of a participating preferred with a $10 million investment for 50 percent of the fully diluted common and a liquidation of $40 million, the investor would then receive the first $30 million (i.e., three times its investment) and then 50 percent of the remaining $10 million. A compromise is sometimes reached to limit the venture capitalist to the greater of its multiple return or what it would receive if there was no participating feature and just a straight convertible preferred. In the prior example, the investor would have to choose between $30 million or 50 percent of $40 million—and the choice is easy.

Other areas frequently debated are whether the unpaid coupon on the preferred will also be credited to the investor upon conversion to common or simply waived. Many founders and strong management teams will also try to insist that their common security will be reclassified as preferred so that their interests and the interests of the investor are perfectly aligned.

2. Dilution Protection

In the United States, a difficult issue in a VC financing transaction is how to protect the interests of the VC investor if additional rounds of financing are required. Venture capital investors typically demand protection against "dilutive" financings. Because any sale of additional ownership interests to a new investor group reduces the existing investors' claims to the company's assets and income stream, the broadest concept of dilution would render every financing dilutive. There are two types of anti-dilution protection: preemptive rights to subscribe to purchase shares in new offerings and anti-dilution protection in down rounds.

Preemptive rights afford the VC investor the right to subscribe to its pro rata share of the next round to maintain its pro rata ownership interest in the company. Although this is straightforward, two issues typically arise. First, should the VC investor have this right in perpetuity (or at least until the IPO)? Many argue affirmatively because the company is not harmed in allowing the VC investor to maintain its position. Oftentimes, however, companies desire to dilute the input of the VC investor and therefore ask that if it ever chooses not to participate in exercising its preemptive right, then those rights are forfeited not just for that round but for all future rounds. A second consideration concerns the exceptions in which preemptive rights are not applicable. These typically include the conversion of the preferred into common, a certain set-aside for an option pool for management, and sometimes "strategic alliances" and similar items. The VC investor needs to be careful in clearly delineating this often undefined phrase or at least have the alliances be approved by the board.

The other type of anti-dilution protection is to adjust the VC investor's conversion ratio if the price per share of the stock issued in any subsequent round of financing is less than the price per share that the VC investor paid for its stock (even if it is a different class of security).

Full-Ratchet Method

The full-ratchet method is the harshest and most punitive VC investor protection against a down round. The full-ratchet method reduces the VC investor's conversion price of its preferred stock from the purchase price paid by the VC investor to the purchase price paid by the new purchaser (or, if the VC investor has already converted its preferred, or has purchased common, the VC investor will be issued additional shares of common at that lower price). For example, if the VC investor purchased 1 million shares of convertible preferred stock at $1 per share, and new capital is raised at 50 cents per share, then the VC investor's conversion price will be reduced to 50 cents, and the VC investor thus will be entitled to convert its preferred stock into 2 million shares instead of 1 million shares. This method has extremely harsh consequences to the founders and existing shareholders because their shares are diluted not only by the down round but also by the change in the VC investor's conversion price. This dilution of the founders' interest is heightened, especially if the amount raised in the down round was an insignificant amount of money. Founders should strenuously resist the full-ratchet method (or any variation of it). It implies that the founders are guaranteeing that the VC investor's stock will never go down in price and that the founders are to blame for any such decline. This logic may be appropriate in the rare case in which the VC investor does not participate at all in decision-making or on the board of directors of the company. In most cases, however, the VC investor is active and also has the ability to veto the transactions causing significant price declines. Compromises include adopting the full-ratchet method for the first 12 months and using a fairer method thereafter, employing the full-ratchet method only if the amount raised exceeds a specified level (to avoid the absurd result of lowering the VC investor's price when only $1000 was raised in the down round), or using the full-ratchet method only if new financing is needed resulting from a breach of representations and warranties or covenants of the company.

Weighted-Average Method

A fairer approach to protect the VC investor against dilution is the weighted-average method. This method also reduces the VC investor's conversion price to a lower number, but that lower number depends on the number and price of new shares issued in the subsequent offering. For example, assume that a company had 200,000 issued and outstanding shares (including the VC investor's 100,000 shares of convertible preferred) before the new offering, and the VC investor's initial conversion price was $2 per share. If the company issued 100,000 additional shares to a new investor at $0.10 per share, thus raising $10,000 in new funds, the VC investor's conversion price would be reduced from $2 per share to $1.34 per share determined as follows:

New conversion price = ((X + Y)/(X + Z)) × Old conversion price

In this formula, "X" equals the number of issued and outstanding shares before the new financing (i.e., 200,000); "Y" equals the number of shares that the new financing would have purchased using the original higher conversion price (i.e., $10,000 would have purchased 500 shares at the original per share price of $2 per share); and "Z" equals the number of shares actually issued as a result of the new financing (i.e., 100,000).This formula should apply only if subsequent rounds of financing are at lower prices, thus locking in their low price per share. Complications arise with warrants and options, as well as with subsequent rounds of financing with prices between the original and new price, or with options taken into account in computing "X" but then not exercised. Careful drafting should also exclude from "X" shares issued for employee options, upon conversion, and due to a merger or a strategic alliance.

Some founders detest the apparent unfairness of the VC investor receiving the downside adjustment of its conversion price with no risk or obligation to participate in the subsequent round. The founder with significant bargaining power may require the VC investor, therefore, to exercise its preemptive rights in order to avail itself of the dilution protection. Some "pay or play" provisions actually require the VC investor to convert its preferred shares to common at the higher original price if it refuses to participate in a new round of financing.

3. Governance

Management of the day-to-day operations of the company, as well as decisions on fundamental issues, present a frequent source of tension between VC investors and founders. Control issues vary dramatically based on the size and stage of each investment.

More and more VC investors are demanding control of the boards even at early stages. They believe that their investment is just too risky to abrogate ultimate control. Founders and earlier investors will obviously resist this and try to remain in control as long as possible. Depending on the size and stage of investment, as well as the relative leverage of the parties, you will occasionally see the board of directors composed of five persons, with one selected by the VC investor, two by management, and one mutually agreed upon by management and the VC investor, with the fifth director being specified as an industry expert or an otherwise experienced person.

Although a VC investor may own a minority of the fully diluted shares of the company (i.e., after conversion of all convertible debt and preferred and options), it will nonetheless typically demand a far disproportionate influence in three respects: voting power, board committees, and information/observer rights.

Voting Power

The VC investor's block of stock will usually possess the power to appoint at least one member to the board. In addition, the VC investor director or block of stock usually has the right to wield negative control in many major matters. For example, notwithstanding the fact that the VC investor may have a minority of the seats on the board, major corporate actions such as the issuance of additional securities, sale or merger, or even hiring or firing of key personnel, may require the VC investor director's assent. The scope of these rights is heavily negotiated. The parties will also negotiate the duration of the VC investor director's right. It may terminate after the next round of significant financing, the passage of time, or the reduction of the VC investor's ownership below a certain threshold. Venture capital investors would be better advised to exercise this voting power right by virtue of their shareholdings, not by virtue of their board representation. Although the law of most states will impose fiduciary duties on the VC investor acting in its capacity as a director and thereby creating considerable conflicts of interest, most state laws impose no such duties on VC investors asserting their rights as shareholders.

Board Committees

The VC investor may require the company's board of directors to establish specific subcommittees for particular tasks and thereby enable the VC investor's director to participate in greater degree in a more focused environment. These committees frequently address audit, compensation, and sometimes technology matters. Venture capital investors will insist that their representatives sit on each of the main committees.

Information Or Observer Rights

Even if a representative of the VC investor no longer serves on the board of directors of the company, the VC investor will often seek to gain access to information to which other shareholders may not be entitled. The VC investor may seek to observe or attend board meetings and be furnished the package of information provided to board members. The VC investor may also obtain the right to receive periodic financial reports and reports of the company's activities.

4. Exit Strategies

Most VC investors have a five- to seven-year time frame in which they expect their investments to remain outstanding before they are monetized. This period may be less if the investment is later-stage growth and pre-IPO and more if it is really early stage. Venture capital investors spend almost as much time contemplating how they will get their money out of the investment as how they will make the investment.

A blueprint to ultimately dispose of the investment, therefore, is a major priority of investors and is a prominent topic during the negotiations. This blueprint for the investor's ultimate exit takes several forms. The most obvious exit strategy for the investor is to use its persuasion powers on the board to package the company for sale or initial public offering at the appropriate time. The investor's basic contractual rights take many forms, ranging from a cafeteria approach of one or more of the following:

- A right to sell to a third party for any price at any time;
- A right to sell subject to a right of first refusal in the other investors and then the company and other owners;
- An ultimate prohibition on sale;
- The right of the investor in certain circumstances to cause the company to be sold and perhaps with certain rights of first refusal held by the other investors and registration rights to permit the investor to cause the company to register the company's stock in the public markets;
- A requirement that an investor continue to invest in subsequent rounds or else have its equity converted to common equity or, at a minimum, lose the aforementioned rights ("pay-to-play" provisions).

Assuming all other approaches do not result in monetization of the investor's interest, the most common exit approach seeks to require the business to purchase its shares (a "put"). The put may be triggered upon the lapsing of time or the occurrence of deadlock, an event of default such as under a bank loan, the company's representations and warranties in the purchase documentation, the departure of one or more key management personnel, or failure to meet certain financial benchmarks. The put price could be either the liquidation value of the preferred equity of the investor or some sort of formula or appraised value for the common equity. Although a formula value is sometimes used (for example, eight times trailing net earnings or a multiple of earnings before interest, taxes, depreciation and amortization ["EBITDA"]), this method can be dangerous because fair and appropriate formulas vary over time and the current risk profile of the business. The put is also of questionable value in a real, practical sense. If the business is doing well, the investor has other means available to it to liquefy its position. If the business is doing poorly, the business may not have a means of financing the put, and therefore, the effect of the put is to convert the seller's equity to the right of an unsecured creditor. Some businesses extract a right to purchase (a "call") from the investors as the logical mirror of a put. The pricing and terms of the call may be the same, except the call right is usually delayed for a year or two after the time that the investor is first able to exercise the put. The value of the put, moreover, may be discounted by a small percentage, say five percent, as the price the investor is willing to pay to gain cash. Conversely, the call may carry a five percent premium (or perhaps a premium that declines over time) to compensate the investor for having its interest redeemed involuntarily. Investors resist calls because they put a ceiling on price appreciation. The company responds that the call is a last resort after the investor has had the right to put the stock. The call treats the investor fairly, moreover, because the price of the preferred is fixed and the value of the common will be fair market value. In the case of convertible preferred held by the investor, the right to call the investor's shares, furthermore, gives the company the ability to require the investor to "put up or shut up" by causing the investor to decide to either convert its preferred to common or suffer a call. Investors will demand the purchase price for the put or call to be paid. This may not be practical, however, because the company may not have this level of liquid resources. As a result, companies frequently seek the ability to defer payment of a substantial portion (usually 75-80 percent) of its put and call obligations for two to three years with a modest interest rate. They may also seek to further defer payment to the extent that any obligation does not exceed a certain percentage (say 25-33 percent) of its free cash flow. These obviously tend to be heavily negotiated items.

Founders may also ask for puts (and expect calls) in some circumstances. Death, disability, and termination of the founder's employment with the company without cause are frequent triggering events. In the event that the founder is terminated without cause, the founder may also seek a right to revalue its put/call price if the company were sold for a higher price within a one- to two-year period. This revaluation right keeps the company honest and prevents it from terminating the founder before a contemplated sale. Finally, payment terms for the puts and calls are essential. If the company cannot afford or does not desire to use cash, it frequently has the alternative to defer payment. The payment period for repayment is usually two to three years shorter with a call (because the company initiated the call) than with a put. The interest rate may also be higher with a call than a put. Granting security to the redeemed shareholder, except for a security interest in the shares being repurchased, is rare. Limiting payments under a put to some percentage of the company's net cash flow should also be considered to ensure that the business can still operate and will not be unnecessarily burdened by the put or call. Finally, acceleration in a sale or change of control should be expected.

5. New Opportunities

Most VC investors try to ensure that the founders or management team devote full-time attention to the venture at hand and no other business. This level of full-time devotion to the portfolio company is critical to give the investment the opportunity to pay off and prevent the founders and management team from bailing out and pursuing more lucrative opportunities at the first sign of trouble. A failed investment will not hurt the management team in the same way that it will hurt the investors. The experience of running even a failed company may actually help build the founders' credibility and track records as they seek to form new ventures.

Founders, on the other hand, desire more flexibility to pursue other ventures. Founders reason that as long as they are devoting sufficient time to the company, they should be free to pursue other opportunities in related or unrelated fields. The founders often believe that their obligations on behalf of the original venture are satisfied if they have instilled that entrepreneurial vision and assembled all of the necessary financial, operational, and research pieces to make that business work. Their creative energies, they argue, should not be stifled while they wait for others to execute their vision.

Venture capital investors react in several ways to management's desire to have more flexibility and freedom to pursue other opportunities. These reactions also span a wide continuum. At one extreme, the investors require the management team to spend all of its business time and energy on the company, at least for the duration of the employment agreement and vesting periods. This position is the most common.

A founder team (in a stronger bargaining position) may still desire greater flexibility to pursue other opportunities. In this case, the investors may agree to let the founders pursue these other opportunities on several conditions.

First, the new opportunities cannot be competitive with the existing company. A second condition is that the founders spend at least the amount of time necessary and proper to ensure that the business model is being implemented. Although these concepts are not capable of being objectively quantified by specific time or financial performance thresholds, these terms convey the sense that the company at issue should initially command the founders' substantial focus and priorities.

Investors will also seek the right, not the obligation, to participate in the new opportunities. If the investors do choose to participate, the battleground is whether they will invest all required capital or just a portion of the required investment. If the investors desire to invest just a portion of the new investment, a minimum portion is typically expected just to show the seriousness of the initial investor. A further complication arises regarding whether the new opportunity should be melded, legally or operationally, with the initial company. This, in reality, requires all investors, new and initial, to agree on a valuation of the existing company to give proper credit for any appreciation in the initial investor's investment, and to agree on a governance structure that shares the investor authority between the initial and new investors. A final nuance involves the allocation of the right to participate in the future between the initial and new investors. Is it on a basis proportionate to the initial investments or on the value of the initial investment at the time of the new investment, or is there a first priority given to the investor in the industry or geographic area that is closest in kind to that investor's investment?

KEY CONCERNS OF A VENTURE CAPITAL INVESTOR • In the United States, the VC investor will rarely make an investment unless all of the following components exist in one form or another. Regardless of whether the company possesses the cure for death and taxes, the absence of one or more of these factors will dissuade an investor from pursuing the opportunity.

1. Valuation

Axiomatically, the valuation must be fair. In earlier-stage companies, however, valuation is more art than science. A company with little revenue, a high-risk profile, lack of depth, or unproven concept, product, or market will be difficult if not impossible to value using classic textbook valuation methodologies. Therefore, an investor will often go by instinct in determining how much it is willing to invest and how much of an ownership interest it desires, and then base the valuation on those factors.

2. Management Team

No matter what the target portfolio company may have to sell, without a talented management team, the product will likely either languish or not realize its full potential. Therefore, VC investors will always exhaustively try to assess the level of talent and experience of the company's management team. How experienced are they? How committed to the business? What are their standards of business ethics? How receptive are they to professional VC investor involvement? Do they need constant oversight or just some occasional guidance? No investment in the world is worth dealing with unmanageable or unmotivated partners.

3. Business Model

Professional investors know how to detect hype and see through sales pitches to the fundamental business rationale for the investment. They will try to verify the feasibility of the company's business model. How scalable (i.e., able to grow and repeat sales without significant new overhead) is it? How novel is it? How susceptible is it to recession or price competition?

4. Technology Or Product

The VC investor will analyze whether it is investing in an entirely new product, a product with significant competition, one that makes incremental progress on the function or the process, or merely a "me too" product. Assuming the product or method of producing the product is distinct and novel, then the VC investor will analyze how protectable the technology or product may be; for example, is it susceptible to infringement or can it be designed around?

5. Competition

So is there an innovative product? A talented management team? A solid business model? If, so that's great, but it isn't a guarantee of success. The risks inherent in the investment intensify when the competition is equally clever, focused, determined, or simply has a lot more money to spend. The annals of business tell the story of many companies that were first to market new goods, but which were eclipsed by wealthier or more aggressive rivals. Careful examination of a variety of factors such as barriers to entry, existing or potential competition, rate of obsolescence of the product or service, and factors driving uniqueness (cost, service, patent protection, and so on) is essential.

6. Size Of Potential Market

Even if the other key needs of the VC investor are met, the investment may not be worth the trouble and expense if the potential return is insufficient. (This becomes more important in proportion to the size of the investment.) The VC investor will always try to estimate the size of the target company's potential market, gauge the growth potential of that market over time, and assess whether the market is likely to be a mere niche component of a larger market or presents a significant opportunity in itself.

7. Generating A Deal Flow

In generating a deal flow, the VC investor creates a pipeline of "deals" or investment opportunities that he or she would consider investing in. It is also common for VC investors to develop working relationships with research and development institutions, academia, and so on, that could potentially lead to business opportunities. Understandably, the composition of the network would depend on the investment focus of the VC investor. Thus VC funds focusing on early-stage technology-based deals would develop a network of research and development centers working in those areas. The network is crucial to the success of the VC investor. It is almost imperative for the VC investor to receive a large number of investment proposals from which he or she can select a few good investment candidates.

8. Due Diligence

Due diligence is the industry jargon for all the activities that are associated with evaluating an investment proposal. It includes carrying out reference checks on the proposal-related aspects such as management team, products, technology, and market. The important feature to note is that VC due diligence focuses on the qualitative aspects of an investment opportunity.

A VC investor tries to maximize the upside potential of any project. He or she tries to structure the investment so that he or she can get the benefit of the upside potential; that is, he or she would like to exit at a time when he or she can get maximum return on the investment in the project. Hence, the due diligence appraisal has to keep this fact in mind.

Sometimes, companies may have experienced operational problems during their early stages of growth or due to bad management. These could result in losses or cash flow drains on the company. Sometimes financing from VC may end up being used to finance these losses. The way to avoid this is through due diligence and scrutiny of the business plan.

9. Investment Valuation

The investment valuation process is an exercise aimed at "an acceptable price" for the deal. Typically, in countries where free pricing regimes exist, the valuation process goes through the following steps:

- Evaluating future revenue and profitability;
- Forecasting likely future value of the firm based on experienced market capitalization or expected acquisition proceeds depending upon the anticipated exit from the investment; and
- Targeting an ownership position in the investee firm so as to achieve desired appreciation on the proposed investment.

The valuation of the firm is driven by a number of factors. The more significant among these are:

- Overall economic conditions. A buoyant economy produces an optimistic long-term outlook for new products and services and therefore results in more liberal pre-money valuations;
- Demand and supply of capital. When there is a surplus of VC or VC chasing a relatively limited number of VC deals, valuations go up. This can result in unhealthy levels of low returns for VC investors;
- Specific deal factors such as the founder's or management team's track record, innovation, unique selling propositions ("USPs"), the size of the potential market, and so on;
- The degree of popularity of the industry or technology in question;
- Valuation offered on comparable deals around the time of investing in the deal.

Quite obviously, valuation is one of the most critical activities in the investment process. It would not be improper to say that the success of a venture will be determined by the investors' ability to value the investment correctly.

Sometimes, the valuation process is broadly based on rules of thumb such as multiples of revenue. Although such methods would appear to be too close to outright guesswork, they are often based on fairly well-established industry averages of operating profitability and assets/capital turnover ratios.

10. Structuring A Deal

Structuring refers to putting together the financial aspects of the deal and negotiating with the entrepreneurs to accept a VC investor's proposal and finally closing the deal. To do a good job in structuring, one needs to be knowledgeable in areas of accounting, cash flow, finance, legal, and taxation. The structure should take into consideration the various commercial issues such as what the entrepreneur wants and what the VC investor would require to protect the investment. Documentation refers to the legal aspects of the paperwork in putting the deal together. In structuring a deal, it is important to listen to what the entrepreneur wants, but the VC investor has to come up with his or her own answers. Even for the proposed investment amount, the VC investor decides whether or not the amount requested is appropriate and consistent with the risk level of the investment. The risks should be analyzed, taking into consideration the stage to which the company has progressed and other factors relating to the project, such as exit problems.

CONCLUSION • Since VC finances growth, VC investment should ideally be used for financing expansion projects (for example, a new plant, capital equipment, additional working capital). On the other hand, entrepreneurs may want to sell away part of their interests in order to lock in a profit for their work in building up the company. In such a case, the structuring may include some vendor shares, with the bulk of financing going into buying new shares to finance growth.

A company almost always has existing directors' and shareholders' loans outstanding before an invitation is extended to the VC investors to invest. Because the money from VC is put into the company to finance growth, it is preferable to structure the deal in such a way as to require that these loans be repaid back to the shareholders or directors only upon IPOs or exits and at some mutually agreed period. (One or two years after investment is a typical repayment period in such situations). Taking this approach will help to increase the financial commitment not only of the entrepreneur in the project; it will help to increase the financial commitment of the shareholders as well.