Venture Capital Financing In The United States And Canada (Part 2)

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Whether the transaction is in the United States or in Canada, the investors usually have the same needs and expectations.

IN PART 1 of this article, we overviewed the broad outlines of the similarities and differences between U.S. and Canadian joint venture transactions, and discussed the first three major structural components of them. In this Part, we resume the discussion and explore the major needs of venture capital investors in any transaction.

4. EXIT STRATEGIES • Most venture capital investors have a five- to seven-year time frame in which they expect their investments to remain outstanding before it is monetized. This period may be less if the investment is later-stage growth and pre-IPO, and more if it is very early stage. Venture capital investors will 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 influence with 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. These include:

- The investor's right to sell to a third party for any price at any time;
- The investor's right to do the same, but 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. (This might include 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.)

Conversely, you will sometimes see 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 (the "pay-to-play" provisions mentioned earlier).

Put Rights

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 (e.g., eight times trailing net earnings or a multiple of 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 impact 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, further, 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 (say 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 was 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.

Canadian Approaches

In Canada, many of the above-mentioned features are also present and, as in the United States, depend upon the relative strength of the bargaining positions of the respective parties at the outset. Sometimes, venture capital investors provide for a discounted call in their favor if an event of default, usually insolvency, occurs. A venture capital investor may be motivated to do so to control the restructuring process. As a matter of public policy, however, the courts have rarely given effect to discounts of any sort that arise solely as a result of an event of insolvency. Nevertheless, considerable creativity in the insolvency arena has also produced exit strategies that, but for the insolvency laws, might not otherwise be available to the venture capital investor, such as the ability to capture and utilize tax losses.

5. NEW OPPORTUNITIES • Most investors try to ensure that the founders and management team are, like Ulysses, "lashed to the mast." Slavish full-time devotion to the portfolio company by management and pure focus on the business at hand are 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 inflict as severe an economic loss on the management team as it will on the investors. The experience of running even a failed company may actually help build the founder's credibility and resume as it seeks to form new ventures.

Founders, on the other hand, desire more flexibility to pursue other ventures either in the same industry or in unrelated fields. 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 feel 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.

Balancing Competing Interests

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 will 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. At the other extreme, the investors may agree to commit additional funds for other investments in the same industry to build the company and give it substance. There is little difference here from the typical Canadian venture capital objective of growing the company through additional capital investment, the development and nurturing of related opportunities, and mergers and acquisitions.

A founder team in a strong bargaining position can often get the investors to agree to let the founders pursue other opportunities on two conditions:

- First, the new opportunities cannot be competitive with the existing company;
- Second, 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.

It is fair to say that except in rare cases, Canadian venture capital firms are very concerned about ensuring that the founders' attention remains on the target and avoids multi-tasking of this sort. Non-competition, non-solicitation, and confidentiality agreements address the same desire on the part of the venture capital investor when there is a parting of ways. Under Canadian law, these restrictions are now more commonly enforced if they are found to be reasonable in geographic and temporal scope and subject matter. This determination varies with each individual situation, so the successful outcome of an application for an interim injunction to restrain the founder from engaging in the prohibited activities is anything but assured.

Participation Rights

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, 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?

Canadian venture capitalists in the small- to mid-market arenas are typically more concerned with the immediate outcome of their involvement with the company, tending to steer clear of other undertakings.

KEY NEEDS OF A VENTURE CAPITAL INVESTOR • In the United States, the venture capital 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 cancer, the absence of one or more of these factors will dissuade an investor from pursuing the opportunity.

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 proven concept of product or market will be difficult if not impossible to value using classic textbook valuation methodologies. Therefore, an investor will often use a visceral feel for value, or back into how much it is willing to invest and how much of an ownership interest it desires and then base the valuation on these metrics.

Management Team

The target portfolio company may have invented the cure for cancer. Without a talented management team, however, the product will likely either languish or not realize its full potential. Therefore, venture capital investors will always exhaustively try to assess the level of talent and experience of the Company's management team. How mature are they? How businesslike? What ethical values do they have? How receptive are they to professional venture capital investor involvement? Do they need oversight and hand-holding or just some gentle guidance? No investment in the world is worth dealing with unwilling, unreceptive, or just unbusinesslike partners who cannot be appropriately managed. In some degree of contrast, studies show that Canadian venture capital investors put less effort into identifying superior management.

Business Model

Professional investors coolly and analytically excuse themselves from the hype of glamorous technology or glitzy presentations and assess the cold hard 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?

Technology And Product

The venture capital 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 whether it is merely a "me too" product. Assuming the product or method of producing the product is distinct and novel, then the venture capital investor will analyze how susceptible the product might be to infringement or reverse engineering.

Competition

Regardless of how novel the product may be, how talented the management team, and how insightful the business model, if the competition is equally clever, focused, determined, or, worse, better financed, then the risks inherent in the investment intensify. History is replete with examples of companies that were first to market with good products, only to be outdistanced by a deeper-pocketed or more aggressive rival. 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.

Size Of Potential Market

Even if these other components exist, the investment may not be worth the time, trouble, and risk if the potential return does not suffice. This principle is particularly true as the size of the venture capital fund increases, and therefore, the need to make larger investments expands as well. This analysis begs the question of whether it is better to own a large market share in a small market or be a bit player in a very large market. In any event, the venture capital investor will always try to estimate the size of the target company's potential market and gauge the growth potential of that market over time (the Internet market 20 years ago was quite small but is hardly in that same place now). Will the market be a mere niche component of a larger market, or is there some real large opportunity? These considerations are as true for Canadian investors as for Americans.

CONCLUSION • In their essentials, Canadian and U.S. venture capital transactions have a lot in common. The investors have roughly similar expectations with respect to returns. They have similar expectations in their dealings with management. Although there are differences in how specific legal protections will operate, the venture capital investors in both Canada and the United States have the same goal: a worthwhile return on the investments they make.

PRACTICE CHECKLIST FOR

Venture Capital Financing In The United States And Canada (Part 2)

- In the United States, virtually all venture capital transactions are structured with liquidation preferences in favor of the investor. Venture capital investors in Canada generally confine their interest to convertible debt, not usually acquiring equity as a principal objective.
- In the United States, venture capital investors typically demand protection against "dilutive" financings. There are two types of anti-dilution protection: pre-emptive rights to subscribe to purchase shares in new offerings and anti-dilution protection in down rounds. Canadian methods of dealing with dilution lie along a continuum and depend on circumstances that affect the negotiation equation. There are significant regulatory barriers to punitive anti-dilution provisions affecting public companies that may not be required in the United States.
- More and more venture capital investors are demanding control of boards of directors even at early stages. The venture capital investor's block of stock will usually possess the power to appoint at least one member to the Board. In Canada, some proportion of the directors (it varies with the statute that governs the particular corporation) must be Canadian residents, as is the case in certain regulated industries.
- Most investors try to ensure that the founders or management team devote full-time attention to the portfolio company by management. Founders, however, usually want more flexibility to pursue other ventures. In both the United States and Canada, the balance is struck through negotiation, and will depend on the specifics of the industry, the nature of the venture, and the leverage of the investors.