The 'secrets' of VC financing terms

The news seems to be improving for entrepreneurs seeking venture capital. Fundraising by venture capital funds surged in the second quarter of 2005 to $6.1 billion, which is the highest quarterly amount in three years. Additionally, a study published by Venture One suggested that venture capital funds are becoming more reasonable about the terms associated with their financings during 2005.

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For some entrepreneurs, however, the economic and other impact of venture capital financing terms are not well understood, and often misunderstood. Valuation is obviously the primary concern for early shareholders, but terms have the potential to dramatically change the outcome for the founders.

Rather than suggest that all terms are bad or each should be negotiated aggressively, entrepreneurs should understand how to evaluate terms and the reasons they are included in typical legal agreements. It is equally important to be able to negotiate terms well with your potential financial backer.

Early investors face challenge

In a recent CEO Roundtable at the Eastern Technology Council, we explored several questions with the discussion leaders and participants on the topic of venture capital terms. These questions included: "How do you evaluate the economic impact of typical VC terms;" "What are the reasons that these terms have made it into legal documents;" "What is negotiable, what isn't and what should you not spend too much time on;" and "Are angels any better?" As in most other discussions with CEOs of emerging companies, the discussion also explored valuation.

Investors in early stage companies face a challenging task when placing a valuation on a company in which they are considering an investment. The reality is that most early stage companies have little "realizable economic value." In other words, at the time of the investment, the company would have little value[1] to a strategic buyer or the ability to create a liquid market for their shares (e.g. and IPO). Nevertheless, the investors want to keep adequate ownership in the hands of management and may face some competition for an investment opportunity.

When the venture capital firm places a valuation on the company, it frequently considers the size of the round relative to the stage of development; the track record of the management team; the valuation of other companies in similar stages of development that they are considering for investment; and maintaining incentive for founders and management.

Terms protect the company

There are many terms that go into a venture capital financing. In general, the purpose of terms is not to punish management or effectively take over daily operation of the company. The real purpose of terms is to protect the investment, protect the company (the company as contrasted to the founding shareholders), and provide incentives for management (including non-founders). Customary terms include the sale of convertible preferred shares instead of common stock, a stated dividend (which may or may not be declared), liquidation preference, anti-dilution protection, redemption rights, participation rights, rights of first refusal, drag along rights, registration rights, and class voting rights.

The liquidation preference followed by the participation rights, dividends and adjustments to the conversion price have the greatest economic impact in most situations. These terms establish how the proverbial pie will be shared once it comes time to divide and distribute. The issue is the size of the pie. If the pie is small, the terms establish that the investors will take enough of the pie to repay their capital and generate a return (if possible), and the remainder of the pie goes to everyone else. If the pie becomes as big as was originally projected, everyone eats well and the terms have a modest impact.

Most terms can be negotiated and a company should be careful of a counterparty's overuse of the word "standard." The decision the company should make is how vigorously each term should be negotiated. Focus on what is important, make a decision and move to the next item.

One of the recurring themes at the CEO Roundtable is that venture capitalists continue to evaluate the CEO based on his or her ability to conduct an effective negotiation. The individual's negotiating style gives indications to the investors about the CEO's ability to close other deals in the future and whether the CEO will be a good partner after the investment is made. If a company negotiates a detailed term sheet with a venture fund, closing should follow within six weeks (if not faster).

Angel terms more complex now

In the recent past, angel investors were considered an attractive alternative to institutional venture capital for the right company and situation. Traditionally, the terms of angel investors were simpler than those of professionally managed funds. With the advent of angel networks, however, their terms are moving towards those of venture funds.

The best resource for evaluating terms associated with a financing is a senior attorney, experienced in venture capital financing. To some, these professionals may seem expensive based on their hourly rate, but they are likely to be more cost effective in the long run and ensure that the financing is closed efficiently.

A new resource is venture capitalist "blogs." One VC blog with a rather extensive discussion of a term sheet www.feld.com.

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[1] We continue to refer to early stage companies and we acknowledge there are many exceptions, but based on many years of experience the majority of early stage companies do not attract high purchase prices.