Module 3: The Venture Capital Negotiation and Investment Process
Deal Structure and Contracting Issues

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1.0 Deal Structure and Contracting Issues

1.01 The Convergent/Divergent Interests of Entrepreneurs and Venture Capitalists

The negotiations that lead to the consummation of a venture capital deal are driven by the wants and needs of both the entrepreneur and the venture capitalist. An understanding of these needs helps understand the typical deal structures and contracting issues that emerge from the negotiation process. Some of the needs of the two parties are convergent and others are divergent. **(Note: For a more detailed discussion of deal structure and contracting issues see assigned readings "Note on Financial Contracting: "Deals," HBS 9-288-014 and "Venture Capital Negotiations: VC versus Entrepreneur," HBS 9-800-170).**

Both the entrepreneur and the venture capitalist have a vested interest in growing the value of the company. Both have an interest in enhancing their own reputation. The entrepreneur is seeking investment capital and the venture capitalist is seeking good opportunities to invest capital. The entrepreneur needs access to expertise and contacts, something that the venture capitalists are usually in a position to provide.

However, they also have divergent interests. The entrepreneur is reluctant give up a share of ownership in and control over the company, a must if the venture capitalist is going to invest. The venture capitalist wants contract provisions to maximize his/her upside and minimize the downside. The entrepreneur is in an inferior position if the company does not perform well. The venture capitalist wants complete and accurate information about the company. For the entrepreneur, this could weaken his/her bargaining position. The entrepreneur is typically devoted to one company on a long-term basis and is often reluctant to sell it. The venture capitalist has a 4-7 year investment time horizon, is involved with several companies, and the sale of an investee company is often the preferred way to exit from the deal

Given the divergent interests outlined above, the deal structures and contracting issues that typically evolve from a venture capital negotiation can be categorized as follows:

1. access to information
2. aligning management incentives
3. controlling decision-making
4. managing financial risk and reward

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1.02 Access to Information

Prior to investing in a company, the business plan and the due diligence process are the primary sources of information for the venture capitalist.

After the investment, the right of the venture capitalist to information is protected in agreements. They will have monitoring rights, representation on the Board of Directors and the right to appoint auditors. The company will have reporting obligations including the provision of regular financial statements.

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1.03 Aligning Management Incentives

Since venture capitalists are always in the position of giving entrepreneurs millions of dollars to use, it is critical that the interests of the entrepreneurs be aligned with their own interests.

Venture capitalists are very concerned with the compensation of the owners and senior management of the companies they invest in. Not surprisingly, they are strongly in favor of a high proportion of stock options and stock grants with vesting provisions that lock key personnel in for a period of time. These are often supplemented with key-person employment contracts.

Performance/forfeiture provisions are common which cause entrepreneurs to lose some of their equity if they fail to achieve milestones or financial targets.

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1.04 Controlling Decision-Making

Since most entrepreneurs are prone to risk-taking, venture capitalists insist on a number of control mechanisms to prevent them from taking unnecessary risks.

They will insist on the establishment of a Board of Directors of the company if one does not already exist. They will insist on having representation on the Board and the right to appoint independent Board members. The Board will be active in hiring and firing of key personnel including the CEO, approval of corporate strategies, plans and budgets.

Super-majority rights are often incorporated in agreements to protect minority shareholders form detrimental actions by majority owners. The venture capitalists often have approval/veto power over key decisions such as mergers and acquisitions and capital expenditures and divestitures.

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1.05 Managing Financial Risk and Reward

Venture capitalists use deal structure to maximize their upside in terms of return on investment and limit their downside exposure in the event that the company does not perform.

Staging of investments in so-called tranches is one way they reduce their financial risk. Instead of putting all of the money in up front it might be advanced in two or three stages. This approach is often accompanied by the "right to abandon" and/or a "right to re-value." This gives the venture capitalist the right to withdraw from the company and/or re-value the company at each stage of investment if the company is not progressing as originally expected.

Venture capitalists also frequently syndicate deals with other venture capital firms. In this scenario, the total investment required by an investee company is shared by two or more venture capital firms. This reduces the exposure of each participating firm and enables them to participate in more deals for a given fund size, thus enabling them to diversify away some of the risk in their investment portfolio.

While entrepreneurs typically prefer the share capital of the company to be in the form of common stock, venture capitalists have a bias towards preferred shares which give them a senior position to the equity held by the entrepreneur in the event of distribution of dividends and/or liquidation of the company.

Anti-dilution provisions are also common and give the venture capitalist rights to purchase securities in subsequent rounds of financing on the same terms offered to outside investors. There may also be restrictions on the issuing dividends and stock splits.

Venture capitalists also lessen their downside risk by placing a portion of their investment in the form of subordinated debt, in some cases earning interest along the way. In the event the company does not perform well, the re-payment of the principal may be superior to the value of the shares they would have held if a straight share deal had been used to structure the investment.

Venture capitalists are also interested in maximizing their upside. This is often accomplished by attaching convertibility provisions to preferred shares and/or subordinated debt. This enables the venture capitalist to convert the preferred shares and/or subordinated debt to common shares at a specified price. If the company performs very well, it may be advantageous for the venture capitalist to convert to common stock to capture a higher upside.

Following are three hypothetical alternative deal structure scenarios, all of which provide the same target rate of return to the venture capitalist on a $1.0 million investment. A description of each scenario is provided on each spreadsheet. They illustrate how deal structure can be used to limit the downside and maximize the upside of the venture capitalist.

Scenario A – Common Shares **(open the Excel spreadsheet ShareDeal.xls in the Spreadsheets folder of your course CD-ROM)**.

Scenario B – A Combination of Common Shares and Interest-Bearing Subordinated Debt **(open the Excel spreadsheet SubDebtDeal.xls in the Spreadsheets folder of your course CD-ROM)**.

Scenario C - A Combination of Common Shares and Interest-Bearing Subordinated Debt that is Convertible to Additional Common Shares **(open the Excel spreadsheet ConvertibleSubDebtDeal.xls in the Spreadsheets folder of your course CD-ROM)**.

For a generic spreadsheet for evaluating alternative deal structures, open the **Excel spreadsheet ValuationDealStructureTemplate.xls in the Spreadsheets folder of your course CD-ROM**.

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