

**Module 4: The Venture Capital Partnership  
Exit Alternatives**

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## 1.0 Exit Alternatives

The typical alternatives available to a venture capitalist for the exit from an investment in a company include:

1. Sell venture capital shares to the owners of the company
2. Sell venture capital shares to the treasury of the company
3. Sell venture capital shares to managers/employees of the company
4. Sell venture capital shares to a third party
5. Sell venture capital shares to the public in an Initial Public Offering (IPO)
6. Liquidate the Company
7. "Hold and Milk"

Following is a brief description of each alternative.



### 1.01 Sell to Owners

In this scenario the equity partners of the venture capitalist, i.e. the entrepreneur and/or other shareholders of the company buy the venture capitalists shares at a negotiated price. In this case the individual or individuals buying the shares have to raise the money to buy the shares of the venture capitalist.



## 1.02 Sell to Treasury

In this scenario the company in which the venture capitalist has invested buys back the shares of the venture capitalist at a negotiated price resulting in fewer shares outstanding. In this case the company has to finance the purchase of the shares.



### 1.03 Sell to Managers/Employees

In this scenario all or a portion of the venture capitalists shares are sold to management and/or employees of the company at a negotiated price. This alternative might be used in combination with either or both of the previous alternatives.



### 1.04 Sell to Third Party

This is undoubtedly one of the more complex alternatives. The entrepreneur may not want to have a third party as a partner replacing the venture capitalist, especially if the third party is a competitor. The third party may want to buy all of the company instead of just the venture capitalist's shares. The entrepreneur may or may not want to sell the entire company. Three parties are involved in the negotiation of the price of the venture capitalist's shares. Notwithstanding the complexities, this alternative is frequently used as an exit route for venture capitalists.



### 1.05 Initial Public Offering

The IPO is often an attractive exit alternative for venture capitalists because it can result in very high valuations. Indeed, assessing the IPO potential of the company is usually a significant component of the due diligence process before investing. **(Note: For a detailed description of the IPO process see assigned reading "A Note on the Initial Public Offering Process," HBS 9-200-018).**

Many venture capital contracts contain provisions that will automatically trigger a conversion of preferred shares held by the venture capitalist to common shares when an IPO takes place.



### 1.06 Liquidate

In this scenario, the assets of the company are sold, the liabilities are paid and the residual value is distributed to shareholders. If the venture capitalist is in a priority position relative to the entrepreneur by holding preferred shares, the amount owing to preferred shareholders is settled before any distribution to common shareholders. This scenario is more likely to be used when the company has performed below expectations.





### 1.07 "Hold and Milk"

In this scenario, the company is likely in a positive cash flow position, but the above alternatives are either not available or are inferior to a strategy of continuing to operate the company at minimum cost and distributing surplus cash as dividends to shareholders. Again, if the venture capitalist is in a preferred position by holding preferred shares he/she might be the only shareholder receiving dividends.



## 2.0 Exit Alternatives and Contracting Issues

Although all parties clearly understand at the outset that the venture capitalist wants to exit from the company 4-7 years after investing, making it happen is not always easy. For this reason venture capitalists insist on provisions in the shareholder's agreement that will facilitate the exit. The greater the exit risk they perceive prior to investing, the more draconian the provisions are likely to be.

Following are some of the contract provisions that can be used to facilitate the exit of the venture capitalist:

- Put Rights

With a put right the venture capitalist can force the company to buy his/her shares at appraised fair market value after a specified time period of time and/or at a point in time triggered by an event such as a change in control.

- Call Rights

With a call right the company can force the venture capitalist to sell his/her shares at appraised fair market value after a specified period of time.

- Drag-Along Rights

If the venture capitalist has a third-party buyer for the company, but the third party wants to buy the entire company, with drag-along rights, the venture capitalist can force the company to sell its shares to the third party at the same price negotiated by the venture capitalist subject to a right of first refusal. The right of first refusal would give the company the right to match the third party's offer for the venture capitalist's shares.

- Tag-Along Rights

If the company has an opportunity to sell its shares to a third party at an agreed price, with tag-along rights, the venture capitalist has the rights to sell his/her shares to the third party at the same price.

- Valuation Process

Most shareholder agreements set out a process that will be used by the parties to value the company in the event that they cannot agree on the valuation at the time of exit. This might involve an appraisal by an independent party or parties and/or an arbitration process. Valuation formulas are also sometimes used but they can be problematic so valuation processes are more common.

