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PRIVATE EQUITY AND CORPORATE FINANCE

ALTERNATIVE TYPES OF FINANCING – THE REFERENCE SOURCE FOR ENTREPRENEURS AND INVESTORS

FOR YOUR BUSINESS

17 Years FYB FINANCIAL YEARBOOK

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DOs and DON'Ts in Negotiations with Venture Capital Investors

Start-ups and companies in the growth phase are dependent on financing of external investors. Due to the specific risk profile, such financing is usually provided as equity – or by equity like financing instruments. Despite the fact that their interests are fundamentally different at the outset, providers and recipients of financing should have the common goal of being reliable „partners" and jointly making the company – with aligned interests a success. In practice, however, it can be observed that even in the early stages of the financing relationship, the success of the company and a prosperous cooperation are often unnecessarily put at risk by inappropriate arrangements and requests by either party.

At first glance, the interests of financial investors – be they business angels, family offices or VC funds – and financing recipients (founders/entrepreneurs) are different. In order to achieve a synchronization of diverging interests, extensive contractual arrangements are typically put in place – the most obvious and most important aspect for achieving such synchronization of interests being the investor's participation in the financial success of the financed company.

Within this framework of an equity/equity-like investment, an investor tries to optimize the conditions of his own investment, especially via the parameters of a low "valuation", assurance of special financial privileges such as "liquidation preferences" and non-monetary "special rights" such as approval requirements or seats on advisory boards. The existing shareholders, with the founders in the front row, regularly attempt to optimize their own position by maximizing the valuation and limiting third party rights to intervene.

In practice, it can be observed that in many financing rounds of young, fast-growing companies, there is often a party with a clearly dominating bargaining power that therefore does not necessarily negotiate with the other side at eye level.

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However, if this bargaining power is used too extensively when entering into a VC investment, which is typically a minority participation, sometimes a contrary effect occurs and the goal of synchronizing interests is missed. The parties follow a mode to optimize their – supposed – individual interests, which is rarely for the benefit of the company and the overall common goal. Against this background, both parties should have an interest from the outset in agreeing appropriate, fair and transparent conditions and parameters to achieve a good and professional cooperation. Even though VC investments in start-ups and growth companies are nothing new, a certain conduct of founders as well as investors can be observed again and again – a selection of such conducts will be discussed in more detail below:

Preparation and team

Key to a successful financing round and often also of sustainable and successful growth is the profound preparation on the part of the company.

DOs

- The founders should be clear about the actual capital requirements (including buffers) in order to achieve the desired growth path.
- The team should cover the necessary core competences within the team and, if necessary, try to complete the team before a financing round or at least communicate the need for supplementation.
- The expectations regarding the evaluation, the scope of a financing round and the essential conditions should be discussed clearly and realistically in advance within the team in order for the team to subsequently speak with one voice.

DON'Ts

- Poorly prepared and with an incomplete team when going into a financing round – "*we are still looking for a CFO*".
- The interests in the team should be parallel and the importance of the individual team members should be reflected in the level of their participation.

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- Excessive discussions in the founder's team about the distribution of shares; disagreement on this point or too little involvement of key people may raise questions regarding the long-term motivation of these people.
- The team avoids the acid test of a valuation and postpones the decision on valuation; instead of accepting investors with a clear valuation, the company tries to postpone the valuation event by using SAFE agreements or convertibles.
- Personal relationships within the founder's team – many investors back away from risks for the company resulting from the fact that personal differences/problems in a relationship may radiate into the company at a later point in time.
- Lone fighters as founders are predominantly viewed very critically.
- Unclear economic circumstances within the group of founders, may lead to a situation in which is influenced by individual financial motives.

Careful but clear Valuation

Valuation is a central parameter for the extent of the investor's economic participation in the company.

DOs

- A realistic self-assessment of the founding team is urgently recommended.
- The level of the valuation usually reflects growth and development expectations and these should not be unrealistically overoptimistic; otherwise the sustainable financing capability of the company might be at risk.

DON'Ts

- A down-round regularly destroys much confidence on the part of investors and deviations from a plan must be extensively explained to the individual investors. This costs time for all parties involved.
- The founders should not present the growth path unrealistically, since if the set growth targets are missed – even if the overall development is positive – there will be major problems in the subsequent round of even matching the valuation of the last round.

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If very optimistic evaluations are asked for by the founders, investors frequently demand provisions on anti-dilution protection in order to protect themselves against a potential "down-round". A balanced compromise could be an anti-dilution protection provision using the "weighted average" calculation formula. Alternatively, convertible bonds are more and more used (not only for bridging purposes) in cases where investors fear a "down round" without appropriate dilution protection.

Appropriate monetary privileges and founder's vesting

The contractual arrangements should include appropriate monetary privileges for the investors:

DOs

- A 1x liquidation preference takes account of the fact that the investor (unlike the founder) actually puts significant financial resources at risk.
- The design of the liquidation preference as "participating" or "non-participating", i.e. the question whether the payments under the liquidation preference are credited against the pro rata proceeds in case of an exit or are distributed in advance. A tried and tested procedure here would be a "participating" liquidation preference with a transition to "non-participating" if the exit proceeds exceed a multiple of 3 to 5.
- Founders should accept or actively offer appropriate "Founders-Vesting", as this is seen as a strong signal of their own commitment to the project.

DON'Ts

- More than 1x liquidation preference – from the investor's point of view this can be opportunistic in the short term – usually makes further financing very difficult and often leads to higher and higher demands from new investors with regard to liquidation preference. The financing capability of the company is thus significantly reduced.
- *No* Founders-Vesting – problematic in case a member of the founding team leaves and still has a significant stake.

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- Founders which prioritize the protection of their own percentage shareholding over the success of the enterprise as a whole (e.g. by asking excessive valuations).

Milestones

Milestones can form an important part of a financing agreement as “intermediate steps” and internal as well as external “checking points” and can be used in order to ensure a constant review of the goals and the progress:

DOs

- Founders should not refuse milestones per se – rather, the agreement of meaningful milestones can be considered a good signal and underpin the confidence in their business concept and the company as such.
- For founders, the agreement of milestones can even lead to better conditions.
- Investors should set milestones carefully and realistically; if a founder considers goals to be unachievable or overambitious, this should be communicated openly at an early stage.
- Only realistic and undisputable, easily verifiable milestones should be agreed.
- Founders should communicate problems on the path to achieving milestones early and openly; agreed strategy changes should also be urgently tracked in the respective contractual documentation in order to avoid later uncertainties with regard to the question of the fulfilment of milestones on both sides.

DON’Ts

- Hardly verifiable milestones or milestones which require the investor’s participation for achievement, as a conflict of interest may arise.
- No abuse of negotiating power by investors in case of milestone violations, but protection of legitimate interests in an amicable environment.
- Changes/additions to the team (CFO must be hired) should not be subject to milestone agreements; the company could be in danger of making a poor – then often expensive – compromise just to meet the milestone.

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Everybody involved must be aware that the agreement of milestones could lead to an inappropriate focus being placed on the achievement the milestones and this can lead to an inefficient use of resources.

Use of funds

If an investor provides fresh liquidity, he expects corresponding information on the planned use of the funds in order to support the growth of the company in the best possible manner:

DOs

- Clear and plausible communication of the planned use of funds.
- Use of funds according to plan and clear communication of any deviations.

DON'Ts

- Fresh Money is only used to fill existing gaps.
- Repayment of existing shareholder loans.

Cap Table / Shareholder structure

For investors, the existing shareholder structure is of particular importance, as it also plays a major role in determining the success or failure of financing for promising young companies:

DOs

- Shareholders who can at least partially participate in another financing round – continued participation of existing investors is a strong sign of confidence in the team.
- All shareholders essentially have comparable rights, in particular with regard to liquidation preferences and rights of co-determination.

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DON'Ts

- A new investor is only taken on board because the existing shareholders (investors) cannot or even worse can but do not want to continue the financing of the company
- A highly fragmented circle of shareholders with different rights has the inherent risk that decision-making may be slowed down to the detriment of the company and is overlaid by individual interests. Many professional investors are afraid of too large a circle of investors and demand a consortium/pool solution.
- Team of founders tries to protect own shares excessively; necessary financing measures are only tackled with delay/too small tickets since the founders try to protect against heavy dilution. As a result, the company takes too small and fragmented financing approach and stumbles from one financing round to the next and the expansion or focus on expanding the business is no longer the top priority.

Participation and reporting

In addition to special monetary rights, information and participation rights are another central element of VC financing. Also in this area, an adequate and well-balanced structure of rights obligations, checks and balances can provide positive support for the company and promote its development:

DOs

- Establishment of an advisory board/supervisory board in which all major shareholder groups are appropriately represented; however, members should not at the same time be part of the management team.
- Appropriate catalogue of transactions requiring approval without interfering with the daily business.
- Monthly "brief reporting", especially on financial matters to stay on track and being able to respond on problems. Reporting in this form should not involve any additional expense for management.

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DON'Ts

- In addition to the approval requirements of the Advisory Board with the majorities specified therein, further embellished veto rights in favor of individual shareholders;
- Listing and anchoring of veto rights in the Articles of Association and an excessive catalogue of transactions requiring approval.

Appropriate ongoing reporting and up-to-date accounting should be without question. Nevertheless, many founders are afraid of committing themselves to any decent reporting. However, even in the case of short reporting cycles, investors should refrain from bothering founders with numerous questions every month – rather, a discussion should take place at quarterly advisory board meetings. Veto rights for individual participants should be avoided.

IP situation

The founders should make sure that right from the beginning there is not a single doubt about the IP situation of the company:

DOs

- Founders themselves finally transfer all rights to the company and are prepared to make corresponding warranties in the financing documentation.

DON'Ts

- Founders withhold individual IP rights and make these available to the company only through individual licenses, etc.

There shall be no doubt that the company, in which the investors are investing, is the unrestricted/sole legal and beneficial owner of all IP and required know-how. The IP will regularly be the central point of investor due-diligence for technology-based investments.

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Summary

The interests within a financing relationship between founders/existing shareholders and new investors are initially (regardless of whether the investor acts in the form of a business angel or as an institutional fund or as a strategic investor) not aligned and there is a high degree of information asymmetry.

While the information gap can be at least partially resolved by a combination of information provision and contractual assurances and this can provide the joint basis for an investment, an appropriate and balanced structuring of the rights and obligations within the financing relationship is essential to jointly lead the cooperation of founders and investors to a success. In contrast to a classical M&A deal aiming at taking control, a VC financing aims at a mid-term (sometimes unintentionally long-term) cooperation and at achieving the goal of building up companies and successfully "exiting" them. Both parties should be aware of the legitimate interests of the other side and open to implement an appropriate economic framework and conditions as well as control and participation rights. Some of the most important points have been raised.

Admittedly, for the specific design of the provisions of a participation there is an unidentifiable number of different provisions and details, the specific design of which are also determined by the individual negotiating power and skill, information asymmetry and individual assessments and experience of the participants.

The aim should be to implement clear, fair and feasible provisions that are appropriate to the stage of the development of the company and that positively support the development of the company. In this context the work of the joint working group of the Business Angels Network Germany (BAND) should also be mentioned as well as the Federal Association German Start-ups, who have tried to put together a set of balanced templates such as for a convertible loan or a term sheet for an equity financing round (www.standardinstitute.de). This is the best way to combine the different positions of founders and investors.

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About the author:

MAURITZ VON EINEM regularly advises institutional investors (private equity and venture capital) as well as young companies on financing and M&A transactions and tax law. Prior to joining ARQIS he worked in the Hamburg office of Freshfields Bruckhaus Deringer LLP in the area of transactions/tax law. He studied business administration and law at the Universities of Göttingen and Geneva and worked as a research fellow at the Max Planck Institute for Tax Law in Munich. ARQIS is an independent commercial law firm operating in Germany and Japan. The firm was founded in 2006 in Düsseldorf, Munich and Tokyo. Approximately 45 professionals advise domestic and foreign companies at the highest level on all core areas of German and Japanese business law.

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