A Publication of the NJ Technology Council and the Education Foundation

NEW JERSEY TECHNEWS

March 2002 Vol. 6 Issue 2

Will You Still Love Me Tomorrow?

Five Things I Should Have Asked My VC Before I Cashed the Check

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A few years ago, lawyers spent time helping CEOs evaluate numerous competing term sheets, each one bidding the valuation ever skyward. Hindsight has revealed that, for many entrepreneurs, sky-high valuations and generous terms were not necessarily synonymous with the best deal. In the current venture environment, most CEOs will vouch that venture capital transactions are more like strategic alliances than fundings - thus, the critical emphasis should be whether a given investor will be a good business partner.

What makes a good partner? For starters, entrepreneurs and their backing venture firms should have similar expectations, objectives and styles, and entrepreneurs ought to be willing to trade valuation dollars and liquidation preferences to find the right match. This article synthesizes anecdotal data to yield the five questions that capital-seekers should consider before closing a venture round.

1.Can I speak with some of your existing portfolio companies to see what it would be like to partner with you?

Just as you would call references when hiring a contractor to remodel your home, entrepreneurs should speak directly with some of the VC's existing portfolio companies to gauge what it would be like to work with the VC. Conversations with portfolio CEOs should help you anticipate what to expect when (1) numbers miss projections, (2) it is time to do the next round and you need help finding new investors, or (3) you want to make basic management decisions but need guidance rather than someone scrutinizing your every move.

These conversations should also reveal how hands-on, accessible, sophisticated, connected, equitable, understanding, adversarial, and insightful your potential VC will be when working with you to build your business. You should also investigate the VC's role in finding strategic partners and/or clients for portfolio companies. Given the lengthy period between investment and exit (IPO or otherwise), you should expect to have a multi-year relationship with your investors. Finding a cultural and philosophical fit is essential to a good investor-CEO relationship.

2.What do you view as your role in finding other investors in future rounds?

A company's holy grail is consummating the investment round that will take it comfortably into profitability (a "fully funded business plan") so that the company won't run out of "runway" (enough cash to feed its burn rate until profitability). Unfortunately, some ventures get less than fully funded and start looking into whether their investors have kept in reserve additional money to invest in one, two or three follow-on rounds to enable the company to survive until breakeven or profitability. That extra money ("dry powder") is critical. Too many companies have assumed that the ease with which the first round was raised will be replicated in successive rounds: not true in this market.

The difference between death and survival can be the VC's willingness to continue to fund the company. In many cases, the VCs will bring in the new investors or will consume the round themselves. You ought to know in advance, however, whether your VCs will be there for you in round two, both with their own checkbooks and with their friends'. It is a particularly good sign if they have brought friends to the party in the first round - this is evidence of their ability to bring investors in at a later stage and diversifies the pool of likely second round funders. Of course, building staged investments into the deal is another way of reducing the risk of being underfunded or of having to trade away too much in subsequent rounds.

Continued on back of page

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Continued from front of page

Finally, companies should be sure to start negotiating round two well before (at least six months before) they begin to run out of runway.

3. Who will answer the phone when I need guidance or approval for business decisions?

Most venture transactions contain protective provisions - clauses that require the company to obtain the VC's approval before licensing away patents, acquiring a business, firing a CEO or making other significant business decisions. In addition, VCs tend to end up with board seats and other approval rights as holders of preferred stock. These contractual obligations empower the VC to participate in many of the company's significant business decisions. A seasoned VC who lends expertise and access to potential strategic allies, customers and advisors can make for a terrific business colleague. Ideally, companies wanting additional input on critical decisions will proactively seek their VC's business insights (whether or not technically required to do so) and feel assured of ready access to their backers. How likely is it that your proposed investor will be trekking in Nepal for two months while you wait for an answer or worse, that the person in charge of your business relationship will lack familiarity with the hurdles facing your sector?

Understanding the degree to which your investor will want to participate in core decisions is as important as honestly assessing the extent to which you, as an entrepreneur, will want to be answerable to a strong board.

4. What happens if the company falls short of projections which we think are way too conservative and you think are pie in the sky?

Most VCs understand that portfolio companies don't always meet the timeline and numbers in the business plan. However, VCs handle a company's failure to meet projections in many different ways. Some investors may quickly grow disenchanted and start to punitively micro-manage day-to-day operations. Other VCs will work collaboratively with the company to determine the cause of the failure and help strategize remedies. It is relevant to consider whether the VC will provide a creative sounding board when management needs to vet important issues. This is clearly something to ask existing portfolio companies - since any reputable and invested VC will have portfolio companies that have missed projections.

You will also want to explore the extent to which your VC has dry powder for follow-on investments in your company. If targets are not met, the company will likely need additional funding sooner than anticipated — at a time when it may be a less attractive investment candidate. At those times, existing VCs often provide interim financing to bridge the company until a liquidity event (sale of the business or IPO) or a subsequent round. Absent an additional investment by existing VCs, and given the long leadtime needed to consummate a round with new investors, the company may have no realistic financing source.

5. What is your philosophy on providing incentives for management?

Each VC round restructures the financial ownership of the company so that the management team (holders of common stock) will not start to see cash in the event of a sale of the business until increasingly significant preference payments have been made. Consequently, executives may find that they don't get a dollar until $10 or $20 million has gone to the VCs. VCs always say that they are investing in a management team. Discuss with potential VCs the ways in which they have worked with portfolio companies to keep management "in the game" through successive venture rounds.