

VENTURE CAPITAL INVESTMENTS IN 2003

By Michael Thompson, Partner, Steptoe & Johnson

Introduction

In the current economic environment venture capitalists investing in businesses requiring expansion capital are behaving with caution. Not surprisingly, the terms on which venture capital funding is being offered to businesses has changed dramatically from the height of the dot com era.

VCs are now more concerned about protecting the downside than ever before. This is a clear reflection of the lessons learned and experiences suffered by VCs in recent years.

Issues

The following is a list of issues and concepts commonly found in VC transactions. These issues and concepts reflect the change in the approach adopted by the VC community in terms of the documentation put in place by themselves to protect their investments.

1. **Milestone Funding** – Where VC financing is intended to fund business operations going forward rather than to repay outstanding debt, then in such circumstances milestone funding may be used. Under these arrangements, the VC agrees to release funds at certain points in the future based on the satisfaction of certain negotiated milestones relating to such matters as revenue generation or the completion of certain key customer contacts.
2. **Price Based Anti-dilutions** – Investment agreements now usually will contain provisions whereby if the company issues shares in the future at a price which values the company at less than when the VCs subscribed, then the VC will be entitled to receive further shares to enable the VCs entire shareholding to reflect the revised valuation for the business.
3. **Involvement in the management** – More and more VCs are insisting on board representation. The VC nominated director will usually play a pro-active role in the development of the business. The individual concerned will often have networking connections that may be useful for the development of the business. The performance of senior management will be closely monitored by the VC on a regular basis and steps will be taken to replace underperforming executives.
4. **VCs preference on proceeds on the liquidation/sale** – On the liquidation of the company, VCs are seeking specified multiples often two to three times their original investment to be returned to them before any proceeds are distributed to the other shareholders.

VC's are also insisting that on the sale of the original investment made by them the VC will be repaid first from the proceeds of sale and will then participate in the remaining proceeds of sale with all other shareholders.

5. **Share Options** – Although still an important instrument for incentivising senior management, certain VCs are not inclined to accept the dilution of their shareholding on the exercise of management options prior to the second or third round of funding or even before an exit is achieved.
6. **Mandatory Redemption** – VCs will also seek to include provisions which confer protection if the redemption of the share capital is the only basis on which an exit can be achieved. Returns sought on a mandatory redemption can significantly exceed the original investment cost.
7. **Dividends** – Certain VCs indicate an interest in securing dividends either during the course of an investment or as part of an exit. The rights attaching to such shares would provide that dividend rights are cumulative. The coupon will also increase if the projected exit date is missed.

8. **Negative Control** – The inclusion of appropriate restrictions on the conduct of the business in favour of the VC is not new. There does in fact appear to be a greater interest in using these controls to ensure that the company is led in a manner which will protect the VCs investment.
9. **Drag Along Right** – In addition to obtaining tag along rights certain VCs are now requiring drag along rights to ensure they can force an exit in pre-determined circumstances. Such a provision can be obtained even though the VC, as is the custom, will not give warranties or indemnities save as to the title to its shareholding interest.
10. **Valuation Adjustments** – If the company fails to achieve specific milestones there can often be a downward adjustment to the company's valuation and an equivalent upward adjustment to the VCs own interest so as to put the VC in the same financial position as if it had invested at the lower valuation.

Conclusion

In view of the recent downturn, VCs are taking greater care to protect themselves. This is even more in light of the pressure that investors are putting on VCs to ensure that the funds that are available to be invested by the VCs are invested not only sensibly, but also with due care and attention in case the investment is not as successful as originally envisaged.

In light of this pressure, and although some of the above provisions are not totally new concepts to the VC community, such provisions will appear much more prominently in transactions than was the case in the late 1990s.



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