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Change Is Afoot: Seasoned Serial Entrepreneurs Are Altering VC Rules

By John Yates, Special To LTW

Editor's note: John Yates, a regular contributor to Local Tech Wire, chairs the Technology Group of the law firm Morris, Manning & Martin, LLP.

ATLANTA - There's a new breed of entrepreneur raising capital in the Southeast. Certainly, there are still first time start-up entrepreneurs who are scrapping for early stage capital. But a more seasoned group has emerged to change the rules of the VC game.

These seasoned entrepreneurs have several characteristics:

- Previous business experience.
- Successful prior business ventures
- A history of senior management responsibilities.
- Significant net worth.

As a result, these so-called *serial* entrepreneurs have a different set of interests in the capital-raising process. They are less interested in the color of money and more focused on the value-added benefits of a financial or strategic investor.

The serial entrepreneur is a unique and misunderstood breed in the VC area. Most VCs view the tech market as an "investor-friendly" environment – the VCs have the money and the companies are having a difficult time finding it. Therefore, the VC may have the upper hand in setting valuations, dictating terms and establishing liquidation preferences.

The serial entrepreneur simply won't follow these rules. Rather, there are a new set of criteria they're using to judge their prospective business partners/investors.

Industry Experience and Knowledge: Many VC firms have gravitated to the "hot" areas – business process outsourcing, biotech and life science, and security and government sales. However, the venture funds often have limited knowledge and experience in these markets.

The serial entrepreneur wants an investor who knows more about the market than the entrepreneur. Too often the VC fund is oblivious to its blind spots in this area. Their money is green so that should be good enough. But it's not for the serial entrepreneur.

You Talk, I Listen: The serial entrepreneur is interested in hearing about the value-added benefits from the prospective investor. They want to know answers to some important questions posed to the VCs:

"What is your research capability in our market? Are any of your partners (yes, partners – not associates) directly involved in the market and related research?"

"How many other investments have you made in the market? Are any of them competitive with our company?"

"How do you protect the confidential information that I may be sharing with you?"

"If you were a member of our Board, who could you introduce to the company – prospective customers, management talent, strategic partners and investors?"

Let Me Tell You About Us – But Not Too Much: Traditionally, the communication between a venture capitalist and a prospective portfolio company has been one-sided. The venture capitalists have asked the questions, and the entrepreneurs have done their best to answer them. There has been very little "sales pitch" by VCs. You can't blame the VC funds – they had more opportunities than they could ever pursue, so why spend much time talking about yourself.
With the serial entrepreneur, the communication has changed.

Entrepreneurs are more cautious than ever in disclosing confidential information regarding business plans, product development activities and financial information. The serial entrepreneur may be willing to provide sufficient information to allow a venture fund to ascertain an interest in the company and determine valuation. But the days of sharing the "secret sauce" without a nondisclosure agreement are over.

The Suspicious Entrepreneur: The experienced entrepreneur is suspicious of the "focused" venture capitalist. This type of venture capitalist is concentrated on a defined market and the competitors in the space. Often, these venture funds will locate the leading private companies in a market and meet with them to pick the leaders. As a result, the serial entrepreneur may be appropriately skeptical of these VCs.

Understandably, the serial entrepreneur will require the focused venture fund to sign a nondisclosure agreement. While most funds are reluctant to do so, they may find that their signature on an NDA is a condition to meeting with the serial entrepreneur.

Excuse Me, But I Don't Need Your Money: The serial entrepreneur may be fully capable of funding a start-up venture. There may be no burning need to raise outside capital. However, the entrepreneur may elect to involve a venture fund for several reasons:

- The VC may have helped the entrepreneur in a prior business venture – and this is a way to repay the VC for its kindness.

- The venture fund may have limited partners that are potential customers of the entrepreneur's new business venture.

- The VC may have a dynamic partner that will bring significant value to the Board of the entrepreneur's new company.

Customers Really Do Matter: When it comes to Board participation, VC investors are gauged differently today than in the 1990s. Contacts with strategic partners, prospective customers and sources of business are key.

The serial entrepreneur generally understands the financial aspects of the business – and does not need multiple advisors to address financial matters. The best investor may be the VC fund that can supply an outside Director with important contacts and relationships with key prospects and strategic opportunities.

Less Onerous Terms and Conditions: Serial entrepreneurs often invest their own money in the business venture. Frequently, this may be a substantial investment resulting in majority control of the business. The entrepreneur may "invite" venture investors to become shareholders.

As a result, the terms of investment are more palatable to the entrepreneur than in your typical venture investment. The entrepreneur may veto commonly accepted contract provisions such as negative covenants, piggyback rights, and forced redemptions. The venture investor may be left with a take-it-or-leave-it deal. These types of investments look more like private placements than negotiated venture capital transactions.

The serial entrepreneur has added a new dimension to venture investing. A new set of rules has emerged where the serial entrepreneur often calls the shots in the transaction. Look for more changes in the area of venture investing where experienced entrepreneurs are involved.

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