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VC Is Still Available Across Southeast – But It's Not Cheap

By John Yates & Jeff Hay, Special To LTW

Editor's note: John Yates, one of the technology leaders in the Southeast, writes a weekly column on Wednesdays in LTW. Jeff Hay, a fellow partner with Yates in Morris, Manning & Martin, is co-author of this week's column.

ATLANTA - Good news. Venture capital is still available in the Southeast. Yes, VC money is available, but at a cost. And rightfully so. Venture funds must show a significant return on investment to their limited partners. With exits more difficult to achieve (the IPO market is ice cold), VCs have been required to change the terms for making investments in entrepreneurial ventures.

With this background, let's informally review the key terms of venture investments in 2003 in the Southeast.

1.Alphabetical Rounds – An informal survey of venture financings in the Southeast shows an understandable trend – the letters keep progressing through the alphabet. There are more "C" and "D" rounds of financing than early stage or "A" ones. This reflects at least one positive trend - that investors are willing to put more capital to work for selected portfolio companies.

At the same time, these later rounds reveal a critical need of portfolio companies. They must have fresh capital to fund their business plan through ongoing operating losses – hopefully leading to an eventual positive cash flow.

2. Larger Rounds – On the West Coast, an informal survey was recently conducted of venture financings in '02. The survey disclosed that later stage rounds are much larger in size than in previous years.

Several recent Southeastern venture deals have followed this trend. Large, double digit transactions in our region include New South's $62.5 million fourth-round of venture financing (Greenville, SC); the $40 million investment by Summit Partners in Fleetcor (Atlanta), TriVirix International's $23 million fourth-round financing (RTP), Elogex' $17 million fourth-round financing (Charlotte) and a number of VC deals in the Atlanta area in the $18-25 million category.

3. New Investors – Thankfully, many of our Southeastern-based funds have shown ongoing support for their portfolio companies - Noro-Moseley, Wakefield Group and Frontier Capital among them. However, as a by-product of these larger rounds, new investors are often joining the VC syndicate.

There is often a need to bring in new blood to a deal. The reasons are twofold – the size of the deal may be beyond the existing investors fund limits. Secondly, existing investors want an independent party to set the valuation for the round. For legal reasons, the existing investors can better meet their fiduciary duty to other shareholders by having a third party VC firm set valuation for the financing.

4. Expect a Down Round – It’s no surprise that a majority of venture financings in the past year have been at valuations lower than the previous round. The West Coast survey of ’02 VC deals indicated that 68 percent of the financings in the fourth quarter were down rounds and only 6 percent were up rounds (meaning that the valuation was greater than the previous investment). Look for this trend to continue for several more quarters – or years.

5. Rights Offering – The side effects of a down round can be devastating to existing investors. As a result, rights offerings are frequently included in a down round. These offerings permit existing investors to re-invest in the new round – but at the lower valuation. Although existing investors may still be diluted, the impact is lessened. However, many of the individual angel investors who invested at the height of the market in technology deals have been unable to continue to invest additional money in new rounds, and have suffered substantial dilution.

6. Capital Liquidation Preferences – The majority of recent VC financings include liquidation preferences, and some of them are very creative. A liquidation preference permits the investor to receive priority on return of capital on a liquidity event. Such events almost always include a sale of the company or a change of control where a majority of the stock is sold to a third party.

A liquidation preference comes in several flavors:

- Participating Preferred -- Participating preferred stock allows the new investors to receive their return on capital and then participate again with the common stockholders in the payout of any purchase price.
- Multiple Liquidation Preferences – A multiple liquidation preference allows the preferred investor to receive more than just their original investment (1x or 100 percent). In the current market environment, given the greater risk and the uncertainty relating to exit, a multiple liquidation preference gives an investor a return equal to a multiple of the original investor (for example, a 1.5x liquidation preference allows the investor to receive one and a half times its investment before the common stockholders receive the balance).

In the West Coast survey of VC deals in the fourth quarter, almost 80 percent had a liquidation preference greater than 1x, and over 14 percent had a multiple between 2x and 3x. Look for this to become the trend in our region.

7. Pay-To-Play Provisions – These provisions have become an accepted term in Southeastern venture capital deals. This term provides for the forced conversion of non-participating investors’ preferred stock into common stock if the existing preferred investor fails to fund a new round of financing. In short, this provision imposes a penalty on an existing investor that fails to continue investing in later rounds of financing.

The West Coast survey revealed that almost 75 percent of the new investments imposed pay-to-play provisions. Our experience confirms an equally high percentage for Southeastern tech companies receiving financing in the first quarter of 2003.

The addition of pay-to-play provisions has narrowed the scope of players in the investment game. Many small venture funds have been unable to participate in follow-on rounds of financing for their portfolio companies. As a result, they have been diluted (or crudely put, crammed-down) by later financings. It's just the reality of the current investment environment.

The result has been a disappearance of early stage investors and the winding down of small Southeastern venture funds like Gray Ventures, Grapevine, and dozens of others.

8. Corporate Recapitalizations – An added twist has complicated the venture financing landscape – recapitalizations. A recap often involves a material change in the rights and preferences of existing investors. This may take the form of a conversion of senior securities into more junior stock.

Frequently, a recap collapses prior rounds of preferred investment and reduces them to a single class of stock. This may result in the consolidation of a Series A, B, C, D, etc. into a new, single class A-1 with similar rights for all investors. The result is a simpler capitalization and easier management and corporate governance of the company.

We can expect to see more recapitalizations as part of the future financing of Southeastern technology companies. Interestingly, the West Coast survey indicates that almost 60 percent of the financings in Silicon Valley in Q4 '02 included some form of recapitalization or corporate reorganization.

9. Non-technology Investments – Finally, we are seeing venture funds across the Southeast that for years only looked at technology deals now investing in non-technology growth companies. While we believe that this trend is a natural shift for the funds in the current market, we expect that the venture funds will return to technology investing when the market improves.

For a copy of the West Coast survey, please send us your e-mail request.

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