Reviewing Mechanics of Venture Capital: Knowing, Dealing With Basics Can Help Forge Winning Partners

By John Yates, Special To LTW

Editor's note: John C. Yates Chairs the Technology Group of the law firm Morris, Manning & Martin, LLP. This is the second of a two-part series relating to Yates' recent visit to Silicon Valley. During the trip he delivered a speech at a national Computer Law Institute and visited a dozen venture capital firms.

ATLANTA - The venture capital market is dissimilar to other business markets and is misunderstood by most technology entrepreneurs. An understanding of the VC business is critical to appreciating the economic drivers that motivate a VC firm to make investments, sell portfolio companies, re-invest or abandon a business opportunity.

There are several key drivers for a venture capitalist. Some of them are based on external factors, while others are unique to the internal operation of the venture firm. An understanding of them is important to predicting the actions of the venture fund.

1. Monday Meetings – Most venture funds conduct Monday meetings of their general partners to review the status of their portfolio companies. In some VC firms, these meetings can be intense and can involve heated discussions regarding the status of portfolio companies and proposed investment opportunities.

For a portfolio company, the executives must recognize the importance of these meetings to your venture partner. No one likes to be embarrassed in front of his colleagues, and the partners' meetings provide a fertile forum for unexpected and often heated criticism. Among the portfolio company issues that may be unearthed at a partners' meeting, the following may be the most common:

- Does the management team need to be changed?
- In particular, do we need a new CEO?
- Have we reserved enough excess capital to fund this business plan?
- Will the company need an unexpected round of additional capital? If so, how much?
- When can we expect a liquidity event (or do we have a "living dead" company on our hands)?
- What do you mean the company is out of cash?

Keep these questions in mind as you prepare your venture investor for the inquisition that may take place at his Monday morning partners' meeting.

2. Liquidity Event – Venture funds are in the business of making investments that could be liquidated through a public offering or acquisition within a set period of time – usually three to five years. They are also driven by a return on their investment that is substantially greater than you can obtain in the stock market or through less risky investments. These are important factors to understanding the motivation of a venture fund.
If you're looking for venture capital for the first time, avoid sending the wrong messages, such as the following:

- We are not interested in being a public company or conducting an IPO.

- We want to be a lifestyle company and maintain our private status for as long as possible.

- We think we have a strong management team and we are all here for the duration.

- To emphasize our long-term commitment we have all entered into employment agreements that are long-term and include generous severances packages.

- Everyone in the company has a change in control provision providing for 100% acceleration of stock options on the sale of the company.

These kinds of statements may greatly concern a VC. In particular, the ability to sell quickly or start an IPO will be critical to the liquidity strategy for the investors. Also, the VC firm will want to confirm that the company is flexible about assessing its management team to confirm which players are suitable for service with a public company and those who need to be replaced.

3. Importance of the Board Meeting - After a VC investment is made, the real work begins. The first Board Meeting following the financing is the honeymoon – everyone is excited about the future and the investors have up to date knowledge from the company (since they have just finished their due diligence prior to the financing). If any surprises arise in the first meeting, then look out for major problems during the remainder of the relationship period. Early surprises could include:

- Early loss of a big customer or prospect.

- Employment or morale problems within the company.

- A legal dispute that ripens quickly into a lawsuit.

- Any irregularity with financial statements or financial controls.

The last point is the most critical. Any irregularities with the financial statements or controls of the company will spell disaster for your chief financial officer and controller. Early in the financing process, these are expected to be iron-clad systems. Difficulties at this stage usually mean bigger problems as the company continues to grow.

For an early-stage tech company, every Board Meeting is a management performance review. Having attended hundreds of Board Meetings during my career, I've found they are one of the few opportunities for outside investors to size up the management team performance. In this regard, key points for executives to consider with regard to their Board Meetings are:

- Always be prepared for the meeting – and reschedule it if you are not ready.
- Provide information in advance to the Directors, and make sure it's correct (or don't provide it at all).
- Never, never deliver seriously bad news at the meeting – if you are aware of it in advance, contact the Directors before the meeting so that they're prepared.
- Keep the Board Meeting on schedule – and display leadership in the meeting

As an entrepreneur, keep these points in mind as you move forward with your venture capital relationship. And always recognize the VC perspective in connection with your business decision making.

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