

## **Founders Find It Harder To Take Cash Out**

By Russell Garland 1/28/2009

For founders of venture-backed companies, the road to an exit keeps getting longer, but the chances to take some money off the table along the way are even fewer in a recession.

The idea that founders and top management should get some liquidity before investors is not a popular one in the venture business. The paradigm is for everyone to pull together to build a great company with financial gains for all shareholders when it goes public or gets bought by a giant such as Cisco Systems Inc. or Google Inc.

Nonetheless, in the years before the financial meltdown some lucky entrepreneurs were able to cash out as venture capitalists battled to back the hottest start-ups. Such stock purchases will be "much less common in a capital-constrained environment where both companies and purchasers of stock would rather see the capital going into the company," says David Cowan, a partner at Bessemer Venture Partners.

The problem for entrepreneurs, and venture investors, is that it can take nearly a decade for a start-up to go public or get acquired, especially now that the IPO market is stopped up.

While private-equity investments into established companies routinely provide complete or partial liquidity to the founders who sell all or part of their ownership stake, this is not the case in early-stage venture deals, where start-ups typically are developing products and testing markets, and their value lies in their high growth potential - not their existing business.

Founders sold existing stock they held in their companies to investors in slightly less than 10% of initial venture financings surveyed for the Dow Jones Venture Capital Deal Terms Report. That percentage probably reflects a number of companies that founders had bootstrapped to near profitability by the time the VCs invested.

"The most important principle in venture investing is to maintain economic alignment among the different parties involved in the company," says Pascal

Levensohn, managing partner and founder of Levensohn Venture Partners, who said his firm has bought shares from company management once in a dozen years and that was for strategic reasons. "We would all like to see everyone get out at the same time." VCs worry that managers won't work as hard to grow the company if they get an early payoff.

### **More Opportunities In Later-Stage Deals**

For venture investors in third- or later-round financings, the dynamics can be different because they sometimes want to increase their ownership stakes beyond what the company is willing to sell. This can be accomplished by buying common stock from founders and top management, or sometimes preferred shares from prior investors.

It's not unusual for later-stage investors to buy about 10% of an entrepreneur's stock, says J. Sanford "Sandy" Miller, a general partner at later-stage venture firm Institutional Venture Partners. "We don't want a situation where we had any kind of management bailout," he says. But "we're looking at late-stage companies, and they often don't need a lot of new capital. It's been a way into some new companies for us."

But even in these types of financings, the economy is having a negative effect because company valuations have fallen, making selling shares to investors less attractive to entrepreneurs, Miller says. Also, investors are more concerned about providing operating capital to the company so it can survive the economic downturn.

Another difficulty that arises when an entrepreneur wants to sell common stock to investors is pricing. Investors buy preferred stock, which has various provisions such as voting rights and liquidation preferences that justify a higher price than common shares. Companies must use accounting standards to set the price of common stock when issuing options, and a private deal between investors and a founder or chief executive can skew this by implying that common stock should have a higher value.

"The bottom line is that if all the entrepreneur has to give up is common stock, and if he's not willing take the common-stock price, that usually kills it," says Michael Conza, a partner at law firm Bingham McCutchen.

Miller says his firm typically values the company as if it were setting a price for preferred shares and then applies a discount. "These private transactions are not definitive on the value of the company's common stock option price," he says.

Others say such transactions need to be taken into account in setting the value of common stock for tax purposes. "It absolutely does affect it, in our experience," says Jason Mendelson, a managing director of early-stage venture firm Foundry Group. "You're pretty much setting the price going forward."

At least one venture firm, Founders Fund, issues entrepreneurs what it calls Series FF stock, which can be converted to preferred stock in subsequent financing rounds. The firm figures this will be easier for the entrepreneurs to sell while still running their companies, along with giving them more control in the boardroom if they hold onto the stock.

But the idea has not been widely adopted in the venture industry. Mendelson, who co-authors a blog about venture capital, "Ask the VC," said it not only raises accounting issues but also "sets up a weird dynamic between the professional investors and the management team, with management expecting they're going to get liquidity before everyone else," and thus possibly having different aims in running the company. The Founders Fund did not respond to interview requests.

### **Buying Common Stock Becomes Less Attractive**

A handful of firms are willing to buy common stock directly from entrepreneurs. Hans Swildens, founder and principal of one such firm, Industry Ventures, said the practice was gaining acceptance in the venture industry in 2006 and early 2007, but that now such transactions are less attractive because, in a weak economy, many companies will have to raise fresh capital by issuing more preferred shares, which have priority over common stock. Buying common stock from founders now is only attractive if the company meets a "long list" of criteria, including having substantial revenue and being profitable or close to it, Swildens said.

What might help investors and entrepreneurs alike is a robust private market for exchanging shares of later-stage, venture-backed companies, where entrepreneurs and VCs could list their stock for sale to potential investors -- a sort of semi-public market for private stock. With the IPO window shuttered and many venture funds nearing the end of their 10-year investment lives, several attempts at accomplishing this are in the works. One is InsideVenture Inc., a recently formed venture financed by a half-dozen leading venture firms. It aims to afford institutional investors opportunities to meet with executives of venture-backed companies along with online access to confidential information about the companies. The company has launched a Web site and scheduled its first investor conference for March in Santa Barbara, Calif.

Steven Bochner, a partner at Silicon Valley law firm Wilson Sonsini Goodrich & Rosati, has recommended some changes to Securities and Exchange

Commission rules aimed at facilitating this kind of market, which are under review by the SEC. One would expand beyond 500 the number of shareholders that a company can have while still remaining private by excluding certain qualified investors from the count. Another would expand upon a current SEC proposal to permit more general solicitation of private-company stock offerings provided that the ultimate purchasers are qualified investors. Currently there is a ban on any sort of public solicitation. Qualified investors are wealthy individuals and institutions who presumably are more sophisticated investors than ordinary folks.

But for now Bochner sees little relief for entrepreneurs hoping to put some cash in their pocket. "I think the need will be there, but I think their bargaining power will lessen in this environment," he says. "I think most venture capitalists would rather have the management team ride it out."