

Venture Capital: The Good, Bad, and Ugly

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A veteran entrepreneur tells you what you should know about venture capital before you sign on the dotted line.

There often comes a time in the life of a startup when the founder must decide if it's better to own a small piece of a big pie. That's because bootstrapping can only take you so far. When you're lucky enough to reach the stage where you have a product that customers really want, a business model that works, and a management team that is itching to take over the world, start weighing your options.

Raising millions through venture capital allows you the luxury of not having to watch every penny. You gain experienced investors who can help you focus on the big picture and plan your growth strategy. But there are many strings attached to this money—it's practically like getting married.

Let's start with the good that comes with venture capital money.

1. Experience, advice, and mentoring. Whether you work in the tech world or the film world, the principles of building a business are the same. Those who have done it before can provide tremendous value. Venture capitalist firms are usually staffed by experienced executives who have not only been successful on their own, but have also watched dozens of startups succeed and fail. They can guide you through your journey.

2. Objectivity. What drives the most successful entrepreneurs is their vision and their determination to succeed at all costs. It's very easy to believe your own press and lose objectivity. Having experienced partners there ready to throw cold water on you can provide a healthy balance.

3. Networking. It's always about who you know. Venture capitalists maintain extensive contacts with other venture firms, executives of firms with whom they've done business or served on boards, investment funds whose money they manage, and so on. Their Rolodexes are usually worth more than their weight in gold if you don't want to make cold calls (see *BusinessWeek.com*, 06/06/05, "Ask for Help—and Offer It").

4. Recruitment. It is hard to know what to look for when you're interviewing for all the diverse positions you have to fill (see *BusinessWeek.com*, 05/19/06, "Countdown to Product Launch, Part III"). What do you ask when you're interviewing a lawyer, for example? How can you tell if the VP of sales is more adept at selling himself than your product? Management teams are usually the top priority of venture capitalists, and they'll help you recruit the best.

5. Credibility/prestige. During the first couple of years of your startup, you'll feel like adding "we've never heard of you either" to every conversation. You can't even get the local press to write about you. Yet everything seems to change when you complete an investment from a venture firm. It's like

joining a special club that gives you respectability. Even customers feel more assured when you tell them about your strong financial backing.

6. Shared risk. Things will go wrong. The market will tank at some stage, deals will fall through, and key employees and customers will defect. Venture capitalists usually have deep pockets and keep reserves for subsequent rounds of funding. Good venture capitalists will support you when things get tough.

7. Big picture. It is very easy to be focused on your product and market and lose sight of the forest. With the hundreds of business plans that VCs review every month, they develop a good feel for the trends.

8. Exit assistance. Nothing lasts forever. If things are going well, you will want to climb the next mountain. But the best strategy may be to cash out and start again. Your venture capitalists will watch for the best exit strategy.

All this seems too good to be true. What are the downsides?

1. Mandatory exit. Venture capitalists are in it just for the money. Most are not out to do good for the world. They manage money on behalf of pension funds, insurance companies, educational endowments, and wealthy individuals.

Their concern is not for your employees and customers, or to build a long-term business.

Their only priority is to sell the company or take it public, so that they can get the 5- to 10-times returns their investors seek. In their world, the need to create high shareholder returns always triumphs over personal relationships.

2. Loss of independence. You may still be the chief executive officer, but you answer to the board now and it's not just your company anymore. The VCs will ask for one or more board seats and the right to veto key decisions and control the firm's capital structure. They will ask you and your managers to sign non-compete agreements. You won't be able to give your stock away to anyone without their approval and they may demand that your stock vests over a three to four year period so that if you leave the company you don't take it all with you.

3. They will have the right to fire you and your management team. You could find yourself reporting to a new CEO, or be ousted from the company you founded.

4. Onerous conditions. Venture capitalists usually ask for:

- Anti-dilution protection. If the company's stock price goes down any time in the future, they get additional stock for free.
- Dividends. In addition to stock, they get a guaranteed rate of return.
- Liquidation preferences. VCs get their principal and dividends back before anyone else gets a penny.

- Participating preferred. They get to double dip—they first get their investment plus dividends, then the value of their stock.
- Mandatory redemption. This requires the company to buy their stock back by a certain date, establishing a deadline for an exit event.
- Demand registration rights. The VCs can force the company to file a registration statement with the Securities and Exchange Commission to initiate an initial public offering—another way of forcing an exit event.
- Approval rights. The VCs must approve any new financings and have the right to participate.
- Reps and warranties. You'll also have to accept personal liability for representations you've made about key aspects of the company. They will have the right to sue you for all you own if you forgot to give them any bad news.

And what's the ugly?

- 1. VC conflicts.** It's a cutthroat world and VCs routinely compete with each other for deals. At the same time, they reduce their risk by co-investing with other firms. The more big backers a company has, the better its odds of success and the bigger the safety net. Yet differences in opinion usually emerge and personal interests often come into play. It can be a full-time job for a CEO to manage VCs.
- 2. Ethical conflicts.** Fiduciary rules require board members to act solely in the interests of shareholders. Yet venture capitalists demand board seats to manage and protect their own investments. Conflicts invariably arise (see BusinessWeek.com, 11/08/05, "Integrating Ethics at the Core").
- 3. Unfulfilled promises.** VCs can only reach out to their contacts for a limited number of favors, and use their Rolodexes sparingly. They also have multiple investments to manage and their own funds to raise. So you don't always get what's promised.
- 4. Egos.** Disagreements about strategy often arise between the entrepreneur who is on a mission to change the world, and the venture capitalist who can do no wrong. Like entrepreneurs, VCs aren't created equal and they often know less than the entrepreneur about the product, customer needs, and market opportunity.

Bottom line: There are no easy choices here. Venture capitalists can be the best thing that happened to your company or your worst nightmare. Your choice is to finance your startup yourself and stay small, or take the risk and raise venture capital. Just be aware that in this marriage, there is no divorce.

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