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## Start-up lenders seek new terms

By Fergal Byrne

Published: July 31 2002 19:15 | Last Updated: July 31 2002 19:15



It was less evident during the technology boom but venture capitalists tend to drive a hard bargain when investing in risky start-ups or expanding businesses. And, in the current financing market for start-ups in the UK, it is hardly surprising to find that tough terms have returned. Entrepreneurs that succeed in enticing investors to their business will need to become increasingly familiar with new deal terms such as multiple liquidation preferences, pay to play and full ratchet anti-dilution - all designed to protect the investors' position.

In part, these deal terms reflect a return to earlier investment norms. "At the height of the boom some investors were doing deals that were not legally prudent and did not contain the deal terms you would traditionally expect to protect an investment. There has been a recognition that mistakes were made," says Martin Bowen, a partner in the private equity team at SJ Berwin, a law firm active in the private equity market.

Venture capitalists argue that tougher deal terms reflect market uncertainty and the increased risk of investments. "The hardest thing right now is to get a strong consensus that any particular market is going to grow dynamically over the next few years. There is a lot of market risk as most technology markets are flat at the moment," says Michael Elias of Kennet Venture Partners.

Liquidation preference provisions allow investors to be repaid their initial investment before management and earlier existing investors receive any return in the event of a sale or liquidation of the company. Essentially, the latest-round investor receives his or her original investment as the first money out - with the balance shared pro rata.

Investors in the UK have always had the option of getting their money out first. "What is new is that investors can demand twice their money out or more. Multiple liquidation preferences are increasingly common, particularly in high-risk financings," says Mr Elias.

According to Mr Bowen, about 50 per cent of current venture capital deals have so-called "two-times liquidation preferences"; and preferences can occasionally be greater, particularly in distressed financings. A two-time liquidation preference means an investor who puts in £5m would receive the first £10m on the sale or liquidation of the company and then share in the balance with the other owners.

The increased return for some investors reduces the share for others such as management and earlier-round investors and can radically change the pay-offs from the deal if the company fails to achieve a high exit valuation. "It all comes down to what the figure is and how it fits with the valuation. It often comes into a deal where the entrepreneur is pushing hard for a high valuation," says Jason Purcell, chief executive of **First Stage Capital**, a corporate finance firm.

Anti-dilution clauses allow an investor to get extra shares in the event of a down round - a round of financing in which the shares are priced below previous rounds. While there are different ways to calculate the scale of adjustment (full ratchet or weighted average),

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this is essentially a means of adjusting the price of the current round to provide protection for investors in case the share price falls. Anti-dilution clauses came into existence at the height of the bull market and, according to Mr Bowen, are now standard in venture capital deals, notwithstanding today's depressed valuations.

A further development is a "pay to play" clause that prohibits investors from benefiting from such dilution protection unless they participate in a future funding round. This clause focuses on the relationship between investor groups rather than between investors and entrepreneurs. "Pay to play is often initiated by syndicate members with the deepest pockets who feel that other investors should not enjoy the same terms if they do not participate in future funding rounds," says Mr Bowen.

What is the advice for entrepreneurs? While they may balk at tougher deal terms, there may be no alternative. "Several venture capitalists we spoke to simply weren't investing in early-stage businesses and others wouldn't consider mobile phones as it was an area of the market where they had been seriously burned before," says Simon East, founder of Cognima, a mobile software company that secured \$5m in new funding this year from Atlas, TLcom Capital Partners and TTP Ventures, the venture capital arm of intellectual property house TTP Group.

And the idea that entrepreneurs may be able to fall back on business angels may be a chimera, according to Mr Purcell. "Many angel investors have been badly burned by the technology downturn and are not investing at the moment," he says.

Mr Bowen suggests that entrepreneurs often have to regard these clauses as "financing pricing terms" that reflect the current price of money in the market. More generally, advisers recommend that entrepreneurs look at the big picture and weigh up the investor as well as the overall deal terms. "It is crucially important to have investors that can really add value to the business and bring contacts and introductions," says Mr Purcell. "Entrepreneurs have to balance the valuation, the terms of the deal and the investor."

At the same time, venture capitalists must be wary of destroying the motivation of management. "During the bubble, companies were being acquired for technology - we made a lot of money from selling technology teams rather than business teams. The reality is that you have got to build a business. And we have got to make sure that the management teams are motivated, which means deals that work for them," says Mr Elias.



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