Follow-On Financings of Portfolio Companies: *Issues for Investors and Start-Up Companies*

FRED DOTZLER

FRED DOTZLER
is managing director of De Novo Ventures in Menlo Park, CA.
fred@denovovc.com

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The most important question for a venture fund to ask when a portfolio company seeks to complete a follow-on financing is the following: Have the objectives that were agreed upon by the investors and management at the time of initial financing been fully met? This question implies that the venture fund and management had agreed to a set of measurable objectives for the use of the proceeds that were invested.

This should not be construed as a contractual obligation of the partnership to provide additional funding if the objectives are met. The investor will want the latitude to decline to invest in a subsequent financing if something that was unknowable in advance surfaces. Many investors want the flexibility to make the investment decision when the financing is imminent. Investors will want to ensure that the risk of the company failing to meet long-term objectives has been sufficiently mitigated. If all objectives have been met and nothing untoward arises, it will be risky for the reputation of the investor to decline to invest in the follow-on financing.

From a fund's perspective it is easier to decline to participate in a follow-on financing when objectives have not been met and when the amount invested to date is minimal. For most funds, writing off investments that represent 1% to 2% of the size of the fund is usually acceptable. For a $300 million fund, a medium-sized fund, this would represent a write off of $3 million to $6 million for a particular company.

If a fund has invested in both the A round and the B round, it is typically a more difficult decision to withhold additional funding, because the amount already invested is now greater. Typically, if investors in a syndicate do not continue to invest, "pay-to-play" clauses are inserted in term sheets by those current or new investors who will invest. If a pay-to-play provision is invoked, the initial investment on a non-participating investor in preferred shares is converted into common stock, which lacks the rights and preferences of preferred (liquidation preferences, anti-dilution, board representation, registration rights, and so on).

When the amount grows to 5% of the fund size, or $15 million for a $300 million fund, decisions to write off investments are much more difficult for venture capitalists. When deciding whether or not to invest in a new round, early investors are not only looking at the return on the new investment amount, but they are also trying to recapture some of the already invested capital. So, the follow-on decision is not an independent judgment.

Typically, the first follow-on financing will be led (terms of proposed investment offered) by a new venture capitalist investor. The pricing of the follow-on round, the B round financing, will be set by the new prospective investor. The valuation will be deter-

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mined by reviewing the accomplishments the founding team has made to date, evaluating the financings of comparable companies in the past, estimating the amount of additional capital required in the future, considering the amount of capital to be invested by the A round investors, and projecting what the company might be worth in the future.

If no new investors offer the company a term sheet for follow-on financing, an insider-only financing can be completed when the existing investors believe in the prospects for a company. The current investors and management will then have to agree upon a valuation for the follow-on round.

MANAGING INVESTMENTS IN EARLY ROUNDS

Given this background, here are some thoughts on how to manage investments in early rounds of start-ups.

Venture investors should carefully evaluate each investment and complete as much due diligence as feasible, considering the time and cost. There are usually a myriad of unknowns at ground zero. For most funds, it is not wise to adopt a policy such as, "We'll invest a small amount and see what happens." Funds are wise to hire consultants to supplement their in-house analysis if they lack expertise or want independent judgment.

Some funds have been structured to invest small amounts ($50,000 to $200,000) in many early-stage companies and invest more only in those companies that make great progress. So long as prospective portfolio companies know this is the fund's strategy, this can work. Here is one caveat: The fund must have sufficient capital to pay for the financial reporting and auditing of all portfolio companies.

Investors should work with the management teams of prospective portfolio companies to agree to a reasonable set of objectives for use of the proceeds. With this in place, there should be less likelihood of animosity if the fund declines to invest more if the milestones are not met. Obviously the fund can continue to invest if they choose, but the entrepreneurial team should not be surprised if they elect to decline.

Early-stage funding is usually sufficient to last the company anywhere from 12 months to 24 months. Venture investors will usually have significantly more knowledge about the prospects for these companies after they have worked with them as the first round capital is being deployed. They will understand the capabilities of the founding team, assess the progress of product development, and confirm whether or not the market is as large as earlier anticipated. They will know whether new, better technology has entered the product development cycle. In the medical technology and bio/pharmaceutical arena, it's important to get confirmation from the FDA that the proposed pathway to approval will be acceptable during this initial stage. It is also important to confirm that payers will provide reimbursement for the product being developed.

Traditional economics suggests that "sunk costs" should not influence follow-on investment decisions because this would not be making the investment decision on its own merits. This is not the case with follow-on investments in early-stage companies because of the factors noted earlier. The follow-on decision is not independent of what has happened during the period when the fund has been an investor in the company.

A venture capital fund that has invested in the A round of a start-up company will have much more knowledge about the portfolio company than they will have with new start-up companies they are evaluating. And with money "in the ground," it is easier to invest in follow-on rounds than it is to fund new companies with many unknowns.

If a fund is interested in investing in an early-stage prospect that requires more capital than the fund would like to invest, it might consider syndicating with another investor with a similar investing profile. In addition to mitigating a possible larger loss of capital, having two investors at the earliest stage can also give the company solid support for the next round, if both decide to continue funding.

Start-up companies should ask prospective investors how much they typically invest over several financing rounds in companies they back to make certain the venture capital fund has the capability to continue to invest. The start-up company should understand where the fund is in its investment cycle before accepting a first-round investment from the fund. Does the fund have sufficient capital in reserve to complete several follow-on rounds of the start-up in the future?

The start-up will have difficulty raising a follow-on round if their initial backers do not invest, because either milestones have not been met or the investor does not have the capital to support additional financings. Management should ascertain whether or not the prospec-

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tive investor has a track record of supporting follow-on rounds when objectives have been met.

The founding team should commit only to milestones they believe they can achieve. They do not want to fall short and face the risk of their initial investors declining to continue providing capital.

For most medical start-ups, there will usually be additional financing rounds beyond the B round to continue product development, complete preclinical testing and clinical trials, and then to begin manufacturing and marketing products. For investors, the analysis becomes more complex when follow-on rounds are done at lower valuations than early rounds, or when new investors demand punitive terms to induce them to invest.

THREE EXAMPLES—YES, NO, MAYBE

To illustrate the points made in the previous sections, the following are three examples of the follow-on investment decision gleaned from companies I've seen funded during my tenure in venture capital.

A venture capital fund invested $4.25 million in a device company targeting a product that would fulfill a supposedly large medical need. Approximately 18 months after funding, the investors had learned that the two-person founding management team was excellent. Several additional strong key positions were filled. The product was developed, and a pilot study confirmed the value of the product to prospective customers. Market research confirmed projections on the potential size of the market. The pathway for approval by the FDA was delineated but not confirmed by the agency. With this strong performance, the fund decided to continue funding the company.

An investor committed $4.0 million to a company developing a device to treat subjects with a particular type of injury. During the first 24 months the size of the potential market was confirmed. The CEO was not effective and developed an adversarial relationship with a co-founder. The product was developed and tested in a small number of patients. Results were positive; however, the company could not get clarification from the FDA on the pathway to approval. Specifically, the company could not identify which clinical endpoints had to be met for the agency to grant permission to market the product. The partnership decided to provide sufficient funding to sell the product and underlying technology to a large medical device company.

Two venture capital funds each invested $3.3 million in a company pursuing a small molecule drug for a market with significant unmet clinical needs. The initial phase I/II clinical trial showed signs of efficacy at the highest of several doses, but subjects were not treated for a sufficiently long time period. Investors realized that the management team would need to be upgraded. The pathway to approval by the FDA was confirmed. The company had elicited significant interest from potential corporate partners. The market need was great and the competitive products inadequate, so both investors decided to invest in the subsequent financing round.

SUMMARY

Clear milestones should be agreed upon by the venture investor and the management team before the initial investment in an early-stage company is made. The decision to invest in follow-on rounds is not independent of what has been previously invested; money is already at risk, and the investor knows more about the company and the markets being pursued. Founding teams should ensure that their prospective venture investors have the funds to participate in follow-on rounds and should be willing to agree to milestones to trigger follow-on financings.

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