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Early exits: the triggers for venture firms to sell their portfolio investments

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Entrepreneurs often swap stories of venture capital firms who attempt or succeed in forcing the sale of a portfolio company against the management team's wishes. Yet there is much that can be done on both sides to prevent disagreements regarding a portfolio company's sale.

In fact, entrepreneurs have at their disposal valuable tools for preventing the untimely sale of your company. But these tools must be utilized at the beginning of the relationship with the venture capital firm.

First, you must make certain that there is a meeting of the minds and a proper alignment of interests when you are initially examining your prospective venture capital firm.

Second, you must work with the venture capital firm to ensure that the investment documentation specifically addresses the circumstances under which a sale would go forward.

Basically, there are four circumstances under which venture capital firms exit investments:

1. following a successful initial public offering;
2. upon the sale, merger, or other change of control transaction company;
3. following the sale of all or substantially all of the assets of the company; or
4. through the company's repurchase of the venture capital firm's investment.

It is important to understand the mechanics of a participating preferred stock investment since it is current the investment vehicle of choice by the vast majority of venture capital firms. With a participating preferred stock investment, the holders of such securities are entitled to receive, on a preferential basis, a "liquidation preference" equal to the amount of their investment, plus a comparable amount per share for any stock dividends that have accumulated on the investment, out the gross proceeds of any transactions that qualifies as a liquidation. This could be a cash sale, a liquidation of the assets. a merger or any other combination or change of control transaction.

In an initial public offering, the underwriters will always require the venture capitalists holding preferred securities to convert them into common stock. Accordingly the features of a participating preferred stock are no longer applicable.

In the other exit scenarios, the liquidation preference is applicable. After the holders of

the participating preferred stock have received their liquidation preference, they will generally participate, on a pro rata basis, in any distribution of assets or stock to the common stockholders, as if the participating preferred stock had been converted into common stock.

With this in mind, it is critically important that there be a meeting of the minds at the inception of the relationship concerning the ultimate decision to sell the company. In a sales transaction that is less than or equal to the liquidation preference, the holders of the participating preferred would be entitled to all of the sales proceeds.

The ultimate protection for management and the common stockholders may rest on the fact that venture capital investors are motivated to maximize their investment return, not just recover their investment. Additionally, the sale of a business generally required approval of a company's board of directors (which the venture capitalist generally do not control), the preferred stock holders (which class of stock the venture capitalists may control), and the common stockholders (which class of stock the venture capitalists generally do not control).

The repurchase of the venture capitalists' securities can take one of two forms: (1) the company can voluntarily agree to the repurchase of the securities at a negotiated price, or (2) the venture capitalists can exercise a "put option" requiring the company to repurchase the securities at their fair market value. The voluntary repurchase of the venture capitalists' securities is becoming a more frequently used exit strategy.

In the case where the company does not have sufficient cash to complete such a transaction, companies may be able to recapitalize the company by leveraging the company, with such borrowing supported by the assets and cash flow of the company. A "put option" is typically included in many venture capital investments so that the venture capitalist does not find himself in an investment with no exit plan. In practice, however, very few put options are ever exercised.

Why? Because, if the company is successful, the investor does not need to exercise the put option. Successful companies tend to either sell the company or take it public. Similarly, the put option is rarely exercised if the company is not successful; in that event, the company cannot buy back the purchase stock, rendering the put option pointless.

In 25 years of investing in hundreds of companies, I have never exercised a put option. And I am aware of many, many firms with similar experiences. The put options are built in to fulfill fiduciary responsibilities to our limited partners-but put options are seldom, if ever, exercised.

The aforementioned checks and balances will usually protect management and the common stockholders in a proposed transaction from which only the participating preferred stockholders will benefit. There may be times, however, where the likelihood of ever realizing a price in excess of the liquidation preference is remote and the participating preferred stock structure was negotiated so that the venture capitalists, generally the last money in, will be the first money out.

Assuming that you have aligned your interests with those of the venture capitalists, and that your investment documentation reflects the conditions for a sale that require the consent of the board of directors and all classes of stock.

Beyond this, what do you need to know about venture capitalists' desire to sell a company? First, the market determines whether a company is suitable for an initial public offering. Venture capitalists cannot control that, convenient though that would be.

Likewise, the decision to actively market the company for sale, or the acceptance of an offer to purchase the company, is typically not in a venture capitalist's hands alone.

These are board and shareholder decisions. Although the venture capital firm will often hold a board seat, the venture capital investors rarely constitute a majority of the board. This is true even if the venture capital firm is a majority shareholder. The reality is that if you have properly aligned your interests on the front end, there is rarely disagreement on the issue when it is time for the sale.

In conclusion, the venture capitalist investor's path toward exiting the deal is straightforward in the vast majority of cases, and the forced sale of a company is exceptionally rare. By engaging in due diligence at the front end of a deal, you can keep it that way.

*About **Jeffrey P. Blanchard** and **First Capital Group**. First Capital Group is a venture capital firm that invests in a diversified portfolio of well-managed early- and expansion-stage companies primarily in Texas and the Southwest, working with their management teams to help build value. As one of Texas' most established venture capital firms providing funds to this traditionally under-served market segment, First Capital Group delivers more than 75 years' combined experience to assist entrepreneurs in obtaining the capital they require to execute their business plans and the experienced counsel they need to help achieve their business objectives. Jeffrey P. Blanchard launched the San Antonio-based firm in 1984, having already held senior management positions in two other such firms. First Capital Group has consistently remained focused on a diversified investment strategy, enabling it to meet investors' needs for a lower-risk portfolio without compromising expected investment returns. First Capital Group originates and serves as a lead or principal investor in all of its transactions. For more information, please visit: www.FirstCapitalGroup.com*