

# GUEST ARTICLE

## CARROTS ARE BETTER MOTIVATORS THAN STICKS



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"Entrepreneurs invariably display greater performance when responding to positive rewards. In fact, for these individuals, fear of punishment and other disincentives are motivation killers."

Since long before venture capital firms existed, the carrot vs. the stick debate has raged. Which is most effective for motivating people—a reward for achievement or punishment for failure?

Throughout recorded history, invaders, explorers, and builders have been motivated by the prospect of sharing in the spoils of their conquests and successes. Their modern-day counterparts are today's entrepreneurs.

Having built a 25-year career working with and helping other entrepreneurs as the founder of my own venture capital investment firm, I have observed that entrepreneurs invariably display greater performance when responding to positive rewards. In fact, for these individuals, fear of punishment and other disincentives are motivation-killers.

In the last few years, however, I've noticed an emerging trend in venture capital and private equity fields that opposes the logic and time-tested methods of motivating management teams to succeed. That trend is the growing use of investment provisions that serve to increase investors' ownership interests in companies that have failed to achieve projected financial performance, with the dilution being borne by existing investors and management.

### The carrot

For the past 25 years in the venture capital field, the incentive stock option has been the most commonly used tool used to enable managers to share in the capital appreciation of a business. An incentive stock option granted to a manager gives that person an opportunity to purchase the underlying stock at almost any time over the term of the option, at an exercise price established when the option is issued. This allows the manager to enjoy the benefit of any capital appreciation on the stock from the date of the grant to the exercise date without investing at inception.

Generally speaking, in order to meet the requirements established by the Internal Revenue Service and avoid taxation on the

option at the time of the grant, the board of directors of a corporation must establish an exercise price for the option that corresponds to the fair market value of the underlying stock. There are obviously many aspects of an option plan that require the help of knowledgeable legal, tax and accounting advisors in designing a plan that maximizes the benefit to the participants and minimizes the financial impact on the issuing company. My intent here is not to provide a primer on incentive stock option plans, but rather to provide an overview that allows the contrast of this traditional "carrot" investment structure with those "sticks" that entail the use of other financial features and instruments to protect investors in the event that planned performance is not achieved.

The most common investment security purchase by venture capital investors is convertible preferred stock. Without explaining liquidation preferences, participation features or other terms commonly incorporated into many convertible preferred stock designations, a preferred stock, in its simplest form, is an equity security that ranks senior to the common stock of the issuing corporation in the event of its liquidation. A convertible preferred stock is preferred stock that is convertible, at the option of the holder, into the common stock of the issuer.

At the time of the initial investment, a VC investor determines the valuation of the company that, based on its expected growth, will translate into an expected return on the proposed investment that is commensurate with the perceived risks of such an investment. The initial valuation forms the basis for negotiating the terms of the proposed investment. For example:

ABC Inc. is seeking an investment of \$5 million to fund further product development, increase manufacturing capacity, expand distribution into international markets and support increased working capital needs. The last 12 months' sales were \$5 million, while EBITDA was \$1 million and the company showed a slight profit. Sales projections reflect reason-

# GUEST ARTICLE

able growth during the next five years. The company currently has no debt. In this example, because of the positive EBITDA, I have assumed a simplistic valuation using a multiple of 5 times EBITDA and valued the net equity at \$5 million. Because the proposed investment is \$5 million, I have proposed that the \$5 million investment would purchase 50% of the fully diluted stock (see Table 1).

This process is much more complex for investments in early stage and startup companies in which no metrics can be used in a quantitative approach to valuation. In fact, valuation of those investments is much more art than science, and tends to place far greater weight on the expected growth and potential future value than on the initial valuation. By analyzing the financial projections and valuing the company using the same EBITDA multiple at the end of the fifth year, I can calculate an expected internal rate of return on the pro-

**TABLE 1**

(\$'000)	
Sales	5,000
Cost of Sales	(2,000)
<b>Gross Profit</b>	<b>3,000</b>
<b>Cash Operating Expenses</b>	
Product Development	(500)
Sales and Marketing	(500)
General Overhead	(1,000)
	(2,000)
EBITDA	1,000
EBITDA Multiple	X 5
Gross Enterprise Value	5,000
Debt	-
<b>Net Equity Value</b>	<b>5,000</b>
Pre-Investment Value	5,000
Proposed Investment	5,000
<b>Post-Investment Value</b>	<b>10,000</b>
Proposed Investment as a percentage of	
Post-Investment Value	50%

posed investment of over 40%, which exceeds my assessment of the risks to which my capital will be exposed (see Table 2).

The investment security in this example is a convertible preferred stock, convertible into common stock on a 1-for-1 basis.

In order to provide the management team of ABC Inc. with positive incentives, I would take into consideration the establishment of an incentive option plan in which 20% of the

fully diluted ownership would be reserved and granted upon the actual achievement of the financial projections. If all options were granted, my initial interest would be diluted from 50% to 40%, reducing my expected internal rate of return to 34.3 percent (see Table 3).

## The stick

In recent years, I have seen and participated in investments that have included what I

**TABLE 2**

(\$'000)						
Year	0	1	2	3	4	5
Sales	5,000	7,500	10,125	13,669	18,453	24,911
Cost of Sales	(2,000)	(3,000)	(3,949)	(5,057)	(6,643)	(8,719)
<b>Gross Profit</b>	<b>3,000</b>	<b>4,500</b>	<b>6,176</b>	<b>8,611</b>	<b>11,810</b>	<b>16,192</b>
<b>Cash Operating Expenses</b>						
Product Development	(500)	(2,500)	(2,500)	(1,750)	(1,750)	(1,750)
Sales and Marketing	(500)	(1,500)	(1,500)	(1,250)	(1,000)	(1,100)
General Overhead	(1,000)	(1,100)	(1,210)	(1,331)	(1,464)	(1,611)
	(2,000)	(5,100)	(5,210)	(4,331)	(4,214)	(4,461)
EBITDA	1,000	(600)	966	4,280	7,596	11,732
EBITDA Multiple	X 5	X 5	X 5	X 5	X 5	X 5
<b>Gross Enterprise Value</b>	<b>5,000</b>	<b>(3,000)</b>	<b>4,831</b>	<b>21,402</b>	<b>37,979</b>	<b>58,659</b>
Debt	-	-	-	-	-	(4,000)
<b>Net Equity Value</b>	<b>5,000</b>					<b>54,659</b>
Pre-Investment Value	5,000					
Proposed Investment	5,000					
<b>Post-Investment Value</b>	<b>10,000</b>					
Proposed Investment as a percentage of						
Post-Investment Value				50%		
Year	0	1	2	3	4	5
Investment Cash Flow	(5,000)	-	-	-	-	27,330
Expected IRR	40.5%					@ 50% ownership

**TABLE 3**

Year	0	1	2	3	4	5
Investment Cash Flow	(5,000)	-	-	-	-	21,864
Expected IRR	34.3%					@ 40% ownership

# GUEST ARTICLE

THE UNCOMMON INVESTMENT  
 QUESTIONS OF VALUE  
 DAVID SWENSON

have come to view as a particularly troublesome variation on the traditional investment structure. This variant typically involves the introduction of a performance adjustment feature to the convertible preferred stock, whereby the percentage of ownership into which the preferred stock may be converted will be adjusted if the company fails to achieve certain performance benchmarks.

The adjustment features that I have seen employed are typically short term in nature, and are generally measured over the first one or two years following the investment. Most have been tied to a profitability metric such as EBITDA. In the typical performance ratchet, if the actual EBITDA over the measurement period is less than the projected EBITDA, the number of shares of common stock into which the preferred stock may be converted is increased by a factor determined by dividing the projected EBITDA by the actual EBITDA. Using the example above, if the measurement period was for years one and two, and cumulative EBITDA was the metric used in the performance ratchet, the projected EBITDA used in the formula would be \$366,000. If actual EBITDA for the two-year period amounted to half of the projected figure, or \$183,000, the performance ratchet would result in the

preferred stock being convertible into twice as many shares of common stock, as seen in Table 4. The effect of this performance adjustment on the capitalization of the company is dramatically illustrated in Table 5.

## Consequences of a stick approach

In my experience, this type of adjustment in ownership typically adversely affects the working relationship between management and the investors. Quite often, poorer-than-projected short-term financial performance can occur without adversely affecting intermediate and long-term potential. Additionally, factors that cause short-term financial performance to suffer are sometimes beyond the control of management. For example, changes in regulatory or tax environment, legal issues or economic downturns. To punitively dilute the interests of existing shareholders—which often includes the holdings of management and the potential ownership represented by management's options—may also ignore the fact that had it not been for the management team's exceptional performance, the actual results might have been much worse, due to external factors.

My experience has shown that the adverse affect that performance ratchets can have on the working relationship between management and the investors outweighs the financial benefit that can result. Recognizing that most performance ratchet adjustments occur within the first two years following an investment, and the average holding period of most venture capital investments is considerably longer, a performance ratchet that results in a strained or potentially adversarial relationship between management and investors is likely to result in more harm than good over the remaining life of the investment.

In order to keep the management team's incentives in proper proportion and to repair the damage to strained relations, it may be necessary to increase the

size of the management option pool, thereby reducing the financial benefits that the performance ratchet was designed to achieve.

Having said that, I have seen instances where a performance ratchet adjustment has not resulted in any harmful side effects. Those examples have generally been limited to situations where the investment was in companies controlled by investors, and the management team has had little actual ownership other than through its options. The dilution imposed on existing investors may not have the same emotional impact as dilution imposed on managers who are either founders or significant investors in a company.

## The carrot and entrepreneurial spirit

Based on our experiences in investments with performance ratchets, we see many more advantages to the use of traditional incentive option plans, where actual option grants are based on positive performance. We find it to be easier to withhold the granting of incentive options, where performance is lagging behind expectations, rather than to reduce a management team's ownership interest through a performance ratchet adjustment.

Entrepreneurs are a unique group of people. The spirit to risk and to create requires respect, and any action that reduces the entrepreneur's ownership can serve to stifle his or her entrepreneurial enthusiasm. Most entrepreneurs work for small businesses because they would not be happy as mere employees of a large company. A belief that has been borne out by our investment experiences is that companies lacking in entrepreneurial enthusiasm are seldom as successful as those led by management teams with significant ownership and whose interests are closely aligned with those of the investors.

Jeffrey P. Blanchard launched VC firm First Capital Group in 1984. It invests in early and expansion-stage companies primarily in Texas and the Southwest. First Capital originates and serves as a lead or principal investor on all of its deals. For more information, see [www.FirstCapitalGroup.com](http://www.FirstCapitalGroup.com).

TABLE 4

(\$000)		
Projected EBITDA	366	= 200%
Actual EBITDA	183	
Original Conversion	Adjusted Conversion	
Shares	Shares	
	5,000 X 200% =	10,000

TABLE 5

	Initial Capitalization		Adjusted Capitalization	
Existing Shares	5,000	40.0%	5,000	28.6%
Proposed Shares	5,000	40.0%	10,000	57.1%
Incentive Options	2,500	20.0%	2,500	14.3%
	12,500	100.0%	17,500	100.0%