"Bridging the Gap

Making Venture Capital Work"

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Speech given at the Venture Capital Partnership Conference, organised by Hong Kong Venture Capital Association and Hong Kong General Chamber of Commerce, on 1 November 2001

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Janine is a partner in CMS Cameron McKenna's corporate and commercial group based in Hong Kong, and has been in Hong Kong since 1991. Janine has spoken and written extensively on the subjects of M&A, due diligence and private equity. She has advised clients on a number of acquisitions and disposals and is mentioned in the Asian Legal 500, the Chambers Legal Directory and Asia Law's Leading Lawyers 2001 survey, as a leading lawyer in the field of M&A, e-commerce and communications.

In addition to being a member of the Law Societies of Hong Kong and of England and Wales, Janine is also a member of the Chartered Institute of Arbitrators.

Janine graduated from the University of Kent at Canterbury, and is admitted to practise as a solicitor in both England and Hong Kong.

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Based in Hong Kong, Tony is a Director responsible for Andersen's Transaction Advisory Services group, and is responsible for assisting Andersen clients undertaking corporate acquisitions and direct investments in Greater China (PRC, Hong Kong SAR and Taiwan) and North Asia.

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Tony has worked for Andersen for the past 14 years, the last 9 in Hong Kong. During the past 12 months, Tony has assisted clients in respect of transactions undertaken in Hong Kong, PRC, Taiwan, Korea, Japan and Thailand. Prior to setting up Andersen's Transaction Advisory Services group in Hong Kong, Tony worked in the firm's Corporate Restructuring department, where he worked with financially distressed corporations and creditors to maximise their financial returns.

Tony graduated from the University of Western Australia. He is a qualified Chartered Accountant and a Fellow of the Hong Kong Society of Accountants.

Why Deals go wrong before investment

A. Introduction

Good morning Ladies and Gentlemen. Over the next forty minutes or so, we propose to discuss with you why venture capital deals might fail.

1. Market/Industry Conditions

We all know that investors' confidence in the venture capital market is faltering. It is only too clear that the world's economy is in a downturn, fuelled not only by the September terrorist attacks in the US, but by the economic conditions that were already causing world economies to falter. Inevitably, in such a time, the venture capital market will likewise experience a downturn, but as we all know, deals can go wrong even in the strongest times of economic prosperity. We would like to discuss this morning some of the reasons why deals go wrong, and how VCs and entrepreneurs alike can minimise the risk of this happening before the deal completes. We will then talk about post-completion failures, discussing what steps can be taken to prevent deals going sour once funding has been put in place.

We are sure with an audience such as we have here today, there is a wealth of experience that may illuminate what we will be talking about, and we would welcome at any time any comments, questions or stories that you might wish to share with us all.

Before we get into the details however, we would like to put this discussion into its wider context. It is very difficult for us to give you some hard facts and figures on the current size and numbers of deals going wrong in the venture capital market. How many entrepreneurs or VCs announce to the public when something does not work out? It has been estimated that only one in every 20 or 30 investment proposals leads to a successfully concluded deal but this is very difficult to substantiate. And we should make the distinction here, between proposed deals that "fail" because they do not even make it to the desk of a venture capitalist, and those that "fail" during the course of negotiations between VCs and entrepreneurs so that the deal never in fact reaches the head of terms stage.

2. **Current levels of successful funding**

We can however, give an indication of the level of successful funding in the US. In the third quarter of 2001, VCs invested US$7.7 billion in 873 companies.[1] This represents a 31% decline from the previous quarter, and a 73% decline from the same quarter in 2000. Clearly, this will have a knock-on effect over here in Asia, but we hope to be able to give you some pointers this morning as to how to minimise the likelihood of a decline of this magnitude occurring in Asia.

3. **The Asian venture capital market**

Nevertheless, there are good reasons why the Asian venture capital market may not suffer quite as much as its Western counterparts, and we consider that there is still an enormous potential for private equity investors in Asia. Regions such as China, India and Japan, with their large populations and relative market inefficiency, can be said to create better investor opportunities than more mature markets.

In our view, Asia has a very positive entrepreneurial culture, and with its attractive investment fundamentals (such as the large pools of low cost labour and manufacturing, and the high degree of investment in the IT infrastructure), we believe that investment in Asia continues to present a good opportunity. Closer to home, in 2000, Hong Kong and China ranked as the eighth most popular venture capital market in the world, and the most attractive market in the Asia-Pacific region itself. China in particular is opening its doors to private equity funding by passing reforms to allow foreign investors to set up joint ventures, wholly owned private equity ventures, or partnerships with Chinese companies, and this will no doubt be further encouraged by China's entry to the World Trade Organisation in November 2001.

Our experience suggests that the venture capital market in Asia is itself still optimistic about its ability to do deals. Hard times present good opportunities. In a recent survey carried out by CMS Cameron McKenna, 52% of respondents expected an increase both in the number and size of deals over the subsequent 12 month period. While this survey was carried out before the attacks in the US, and while we do not expect the economy in Asia to recover fully before the second half of next year, we expect that the Asian venture capital market will not experience the same level of downturn as currently seen in the US and in Europe.

[1] Source: Venture Economics News (www.ventureeconomics.com) 29.10.01

Of course, this is our opinion and we are not fortune tellers! The Asian venture capital market may still take a larger hit than expected, and we would now like to discuss in more detail how you, as VCs and entrepreneurs alike, might try to minimise your risks of deals going wrong.

B. Pre-Investment – Why Deals Fall Apart

1. Investees and Investors

On the side of the investee, there may be several reasons for pulling out of a deal. There may be problems reaching a negotiated agreement with all the existing investors as to the terms of the agreement. It may also be that the founding parties to a project have objections to the deal due to the anticipated dilution of their interest in the project following outside investment. A venture capitalist may find himself negotiating with a founder and then discover that his co-founders are less than happy to allow in new investors. Existing investors may have pre-emption rights under shareholders' agreements which they would prefer to exercise than to allow in a new investor.

From an investors' point of view, there are probably a greater number of deal breakers, bearing in mind that they have to reach an agreement with other investors as well as being satisfied themselves that it is a deal worth pursuing. For instance, it may be impossible to agree on a price or valuation for the deal which in turn leads to pricing differentials. Other contract terms may fail to be concluded. External factors also undoubtedly play a role, and as we mentioned, the recent terrorist attacks in the US is a case in point for freezing the markets. For example, we were instructed to advise a client on an acquisition on 10th September, and then asked on 12th September how to get out of the deal. In terms of the relationship between the investor and the investee, it is often hard to reach a mutually acceptable division of control and influence in the project, as one usually objects that the other has too great a share.

2. Venture Capitalists

VCs themselves pull out from deals for various reasons. Maybe the business is in a sector they do not normally like to get involved in, or perhaps this particular deal does not fit in with their investment portfolio. It may be as simple as the deal not being a good one worth pursuing. A badly prepared business plan very often puts off VCs, as does a business plan which foresees an unattractive rate of return.

Lack of faith in the management's ability to make the project work is often cited as a major reason for VC's walking away from a deal. If the managements' integrity is in doubt, the VC is likely to consider whether the lack of integrity is actually symptomatic of greater problems in the deal. In a recent example, a director failed to disclose to the VCs his bankruptcy; if he had come forward and admitted this early on, the deal would have gone ahead, but his failure to do so left a question mark over whether he has hiding other information and whether he could be trusted. Similarly, poor corporate governance within the company will hinder any investment opportunities.

3. Due diligence

Due diligence may reveal facts which in the end act as deal breakers. Financial due diligence may indicate inaccurate or poor financial results, or projections which are not supported. Legal due diligence can often throw up problems such as flawed title to assets (for example, intellectual property rights being owned by founders or another company, or employees of the company). Recently, a VC client of ours investigated a deal with a large IT technology company. Upon review of the data room, it discovered very poorly drafted documents. The company argued to the VC company that by its very nature, VC investing was a risky business. Nevertheless, the VCs decided not to pursue the deal because of these poor documents. Other investors did invest, and the shares in the company rose dramatically. Some time later however, the company lost SFr200 million and went into liquidation, making the original VC company extremely glad that it had conducted thorough legal due diligence!

Importantly, a venture capitalist will also want to see a viable exit route from the deal in order to avoid being trapped in a deal that is not going to come off.

C. Bridging the Gap

The good news is that all is not lost, and there are undoubtedly ways in which the deal to failure ratio can be reduced, resulting hopefully in more deals reaching a successful conclusion.

1. Investees: background research

Investees first of all can do much to minimise the risk. By doing their "homework", they can take the time up-front to prepare a good business plan. This will be aided greatly if they are willing to give better levels of disclosure to potential investors at the outset: there may be reasons that the deal cannot succeed, and by sharing information sooner rather than later, all parties may save themselves a lot of wasted time and money pursuing a deal which all parties would have seen as unworkable from the start had full disclosure been available.

When choosing which VC to approach with a deal, the investee should bear a few things in mind. First of all, doing some background research into how VCs themselves work will prepare the investee for the what he is getting involved in. Choose one who will add value to the project rather than taking a passive role in the deal. The investee should also select carefully those VCs whose investment strategy and portfolio matches the investment itself. A rejection can be disheartening, even from a venture capitalist who was never going to even consider the deal for the simple reason that it does not invest in that particular sector of the market.

An investee should ideally only approach a venture capitalist when he is absolutely prepared: he should have developed the product, which may be at the stage that it is producing revenue. Cashflow should be positive and if possible, the investee should have established a distribution channel. The whole aim is to pass as many "milestones" on the route to getting a deal off the ground as possible in order to minimise the risks to investors. From a VCs' point of view, they will want to ensure that they are sufficiently protected from risk, and an investee can go a long way to anticipate those risks by proposing strong legal documentation. For instance, adequate representations and warranties, preferences in the event of liquidation, restrictions on the transfer of shares, veto rights and board representations should be worked out so that they realistically reflect the level of protection that venture capitalists will want to see according to the particular deal. They will also want to see anti-dilution rights, exit routes from the deal, and tight service agreements giving investors the right to remove unsuitable management through adequate notice provisions and to protect the deal by making sure that non-compete clauses in the service agreements will sufficiently protect the company against departing management from setting up in competition.

2. Venture Capitalists: understanding the industry and due diligence

So what should a venture capitalist do to minimise his risks of a deal going wrong? One of the most fundamental and essential background exercises that a venture capitalist should do is to understand the business, industry and market of the investee company. This will enable him to analyse as fully as possible what possible risks and characteristics inherent in that industry might have on the outcome of the deal.

In respect of the particular deal, he should conduct proper legal and financail due diligence. When we first arrived in Hong Kong about 10 years ago, very few people, if any, were interested in conducting proper due diligence. Now, people have learned their lessons having got their fingers burned!

To give you an example of a recent case in which the importance of legal due diligence was highlighted: a venture capitalist wanted to invest in a PRC company with the intention of listing the company at a later stage. In fact, it was not properly structured under PRC law and the listing failed. Had the venture capitalist checked whether the company had all requisite PRC approvals for a restructuring before entering the deal, he would have realised that the project was fundamentally flawed and was destined to fail without such approval.

In another example, financial due diligence was not conducted efficiently and the venture capitalist came off badly. He had invested US$15 million in a trading company but six months later the company hit a serious cashflow problem. It subsequently went into liquidation, having lost HK$200 million. Investigation revealed that, although the company had "clean" books with no qualifications, it had in fact had an outstanding debt of HK$200million for the previous four years. A thorough pre-acquisition financial review had not been carried out!

In the legal documentation for the deal, the venture capitalist will want to see appropriate contractual terms to include protection, for example to ensure that there is an exit route if the parties cannot agree a timeframe for the deal. The venture capitalist should also negotiate an exclusivity agreement with the investee: this will afford a degree of comfort and reassurance that the investee is not negotiating with other VCs and therefore waste time and money.

There may be scope for offering an incentive to the managers and owners of the company to encourage their efforts to make the deal succeed. A recent deal went wrong precisely because the management had no reason to ensure the company was a success. The company did not perform and the VCs contemplated selling the business to avoid insolvency. Due to the particularly strong provisions on liquidations and sales preference in the documentation, the management had no incentive to secure sufficient returns for investors in the event of insolvency.

In the current climate, perhaps the message that VCs might be taking away from this discussion this morning is to view investments as a long term opportunity, perhaps taking money out of the project as a dividend further down the track, rather than looking for a quick trade sale or IPO.

Post-Investment – Why Deals Fall Apart

A. Introduction

On somewhat of a light note, a VC has allowed us to cite the story of an underperforming investment which can be put down to seriously bad luck.

This VC invested in a farming project which included fish, beef and cotton. Plenty of analysis was performed prior to the investment being made and a conclusion was reached that cashflows would be evened out.

The site was well located, had good water supply and there was a solid local market for the produce. IRR was calculated as being in excess of 50% per annum. A dam was built on the farm so as to withstand well above average rainfall. The benchmark was to build a dam that could withstand rainfall of an amount equivalent to the heaviest rain in 25 years. To be safe, the dam was built so as to withstand the heaviest rain for 50 years. An assessment was made that if there was a particularly heavy rain, then there may be some loss to the cotton harvest.

The heaviest rainfall for 100 years occurred. During the first 10 days of the rainy season, the cotton was lost. On the 25th day of rain, the water overflowed the dam and guess what – all the fish swam away!

It did not end there – an observation was made that unfortunately, cows are not buffalo and cannot swim. The cows drowned.

B. Why Deals Fall Apart

If the bridging the gap recommendations relating to the pre-investment stage are implemented, then the factors that we are going to discuss now may not be as damaging as would otherwise be the case.

A point to reiterate in the post investment phase is that the VC/entrepreneur relationship is devised to be a fairly long term relationship, and it is not a one off point in time transaction.

To be fair to the investee company, the VC should be prepared to be around to assist the company throughout the investment and be responsive to the company's needs as they arise, rather than a situation where the only time the company hears from the VC is when the VC needs to complete an internal report, or when the VC reads an adverse press release about the company.

In addition, inadequate monitoring of an investment by a VC can lead to a situation where they misunderstand what is happening in the company. Thus, on the occasions that there is communication between the two, this misunderstanding may lead to friction. We are suggesting that there be pro-active communication on both sides – the investee regularly keeping their investors appraised on the status and plans, and the VC setting up monitoring procedures.

There are three areas that we would like to focus on in more detail;

- current market and industry conditions
- financial control
- causes of business decline

1. **<u>Market/Industry Conditions</u>**

Conditions may have led, or at least contributed, to a business not meeting its business plan, particularly in relation to revenue expectations. A number of investments have not worked because the business plan that the VC bought into was not subsequently followed by management. New projects or non-core activities were pursued which resulted in a degree of inattention to the core cash generating business. The flip side to this is that in the current environment, it may be necessary to not only focus on the core business but to go a step further and look critically at the components of the core business, which we will address later.

2. **<u>Inadequate financial control</u>**

A major cause of companies experiencing declining fortunes is either the lack of management information systems or the inability of managers to interpret the information (ie warning signs) to then effect remedies for the business.

3. Causes of business decline

Much analysis has been performed in order to explain why businesses decline. Many cases were identified where external factors such as economic conditions, competition , adverse movements in costs of raw materials etc were identified. However, what was pinpointed was the inability of stakeholders (management, shareholders, lenders) to respond to the situation and to implement remedies.

C. Bridging the Gap

1. Viability of the Business Plan

a) Managing Change in Tough Times

There is a solid argument to suggest that management that are good at managing business growth in good times are not necessarily the types of managers that excel in times of economic contraction, a time that requires companies to be managed in a different manner.

Some investors invest to back existing management whilst others invest on the basis that new managers are brought in. For existing investments, it is recommended that there be a full and frank discussion between the various stakeholders on the benefits that can accrue from bringing in experienced professional managers to devise and/or implement a revised business plan.

b) Strategies for Recovery

There are various strategies that can be adopted in order to boost profits and cashflows. First of all, there are cost reduction strategies, such as the elimination of unnecessary overheads, and requesting discounts from suppliers (after all, if you do not ask, you have no chance of getting!). In most cases, it should be possible to reduce overheads by ten per-cent, without a detrimental effect to the business.

Revenue growth may be boosted by the possible replacement or enhancement of the sales force, perhaps providing them with incentives for good performance. Pricing strategies should also be considered, and raising prices may actually be a preferable option to lowering them in difficult economic times.

A company should also consider refocusing its product and customer market by analysing exactly which products are contributing most to the margins of the company, which are not, and to act accordingly. Reducing product lines may allow fixed asset sales to be made which can generate cash. A critical look should be taken on the company's customer base. The 80:20 rule typically applies – 20% of the customers may contribute 80% of profits. It is normally advisable to cut a number of customers which are not contributing to margins – the sales force can then focus on profitable customers which will help in improving the company's performance.

2. Independent monitoring

As a benchmark, a number of the larger banks have separate recovery departments, which are responsible for dealing with non-performing loans. There is often a separation also of the lending/monitoring function within banks. They do have the advantage of distinct non-performance indicators of a company, for instance, a repayment on a loan is missed, whilst it is not always so easy for investors to spot a drop in performance in the same way.

Banks do, however, place loans on watch lists based upon certain agreed parameters, including regular quarterly reviews or sight visits. Likewise, VC funds could consider having independent people or teams to monitor the performance of investments. Where issues of particular concern within the company have been identified, consideration should then be given to hiring consultants with special skills such as turnaround consultants, to develop a rehabilitation plan for the company.

Conclusion

It is certainly the time to "batten down the hatches" so to speak and to make the necessary adjustment to business plans, operating practices and core focus in order to accommodate the current economic difficulties.

There are undoubtedly, however, funds in the market that are looking for a home. This home will need to be one that is in good order, one that recognises the need to maintain a realistic outlook. Valuations are clearly going to be lower than before, and VCs will be certainly more selective in the deals they enter into. VC's will be performing more detailed due diligence.

The advice to VCs is to scrutinise potential investments closely and get some good advice on how to work existing investments.

For investee companies, a focused, realistic business plan should be prepared. Investors should be carefully sought, targeting the one who is best able to add synergies and experience that will benefit you in the medium to long term.

At the end of the day, this is a business based upon relationships, on trust, and on respect. Communication, above all, is the key.

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