

VC – ENTREPRENEUR ALIGNMENT

Why Is It So Elusive?

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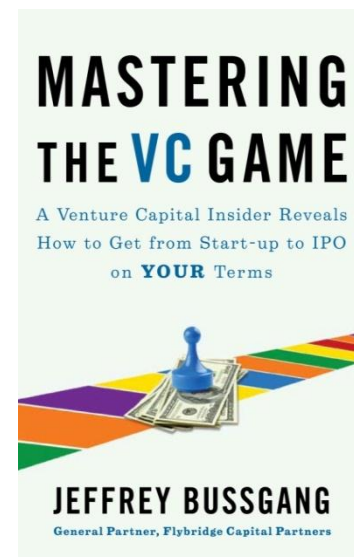


Key Questions

- Can VCs and Entrepreneurs always be aligned or is misalignment inevitable?
- When is an “entrepreneur-friendly” stance the right approach?
- When is an “entrepreneur-unfriendly” stance the right approach?
- How to make sure there’s clarity and trust in the relationship, even with misalignment?

Context For My Perspective

- General Partner at Flybridge Capital Partners, early-stage VC firm based in Boston and NYC
 - 50+ active portfolio companies, Fund III (2008): \$280M
- Former entrepreneur
 - Cofounder Upromise (acq'd by SallieMae), VP at Open Market (IPO '96)
- Senior Lecturer at HBS
- Author: *Mastering the VC Game*
- Blog: *SeeingBothSides.com*



Bottom-Line: Misalignment Inevitable

Entrepreneurs are *human* and care about:

- Change the world
- Ego
- Pride
- Become famous
- Make money for shareholders
- Make themselves money
- Don't screw up

VCs are *human* and care about:

- Make money for their LPs
- Make themselves money
- Ego and Pride
- Make partner ("tenure")
- Build a successful firm
- Raise the next fund
- Peer recognition
- Control if things go wrong

Misalignment Inevitable The Key Is How You Manage It

“Don’t be a victim. It’s not the VC’s fault. Don’t look at [the drama and conflicts] personally, look at them structurally.”



- Mark Pincus, Zynga CEO/founder
Mastering the VC Game

Examples of Sources for Potential Misalignment

- Term sheet – economics, control, “clean terms”
- Follow-on Financing – Inside-Outside Dance
- Feedback – Paula Abdul vs. Simon Colwell; the trick behind good board management practices
- Transparency – respecting chain of command vs. direct contact with management team
- Exit – portfolio approach (VC) vs. portfolio of one (entrepreneur)

Case Study #1: Term Sheet

- What's more aligned – straight preferred or participating preferred?
- Conventional Wisdom:
 - Straight preferred = “entrepreneur-friendly”, “better alignment”
 - Participating preferred = “bells and whistles” “double dip”

Case Study #1: Term Sheet

- Yet...
 - Assume: \$10m investment on \$30m pre in straight preferred, let's say founder retains 20% after pool, angels and other execs
 - Founder gets offer to sell for \$10m
 - VCs get money back, founder nets \$0
 - Founder gets offer to sell for \$40m
 - VCs get money back, founder nets \$8m
- Are founders and VCs really aligned here?
- In a range of outcomes (\$10-40m), they're not

Case Study #2: Follow-On Financing

- Two Series A investors invest \$3m each on \$9m pre to own 20% each
- Company starts scaling fast, doing well
- Series A investors offer inside round at \$25m pre, a 50% step up taking into account option pool increase, getting their ownership to 30%
- CEO thinks she can do better and puts forward an outside-led deal at 100% step up but new investor insists SerA investors must cut back to 15% each

➤ *Are the founders and VCs aligned?*

➤ *How does the picture change if SerA VCs offer CEO 5% points of incremental ownership from the option pool if she accepts their offer?*

Case Study #3: Down Round

- A company struggles to raise follow-on financing, but finally succeeds in getting a term sheet for \$5 million that requires a 50% reduction in preference by the insiders
 - There are two insiders, each with different motivations, price points, and securities, and one is in the middle of raising a new fund
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- *How does the board decide whether to take the inside round or do a bridge?*
 - *What's the entrepreneur's incentive?*

Case Study #4: M&A

- A company doing well, led by a CEO/founder who can scale, gets an acquisition offer for \$200 million, representing a 5x return for your fund.
 - The entrepreneur can “go either way”, but prefers to say no and keep building for the long haul
- *What is the right thing to do?*
- You are about to embark on fundraising.
 - You may make partner in the new fund.
- *Now what is the right thing to do?*

Case Study #5

- What's yours?

Why Is This So Hard?

- Human Nature: Fight or Flight?



- Humans are skilled at avoiding conflict
- In the face of a tough conversation, VCs and Entrepreneurs often shy away
- Everyone wants to be liked and respected, no one likes being a “bad guy”

- VC-entrepreneur misalignment is common, inevitable, natural (“no conflict, no interest”)
- The more informed the entrepreneur, the better – don’t abuse information asymmetry
- When you are in a misalignment situation, identify it, analyze it, don’t shy away from it
- Open, direct conversations and open, direct feedback will lead to trust and respect
- Trust and respect are the necessary groundwork for strong VC-entrepreneur relationship and success
- Recommended additional reading:
 - Stephen Covey, *The Speed of Trust*
 - Patrick Lencioni, *Five Dysfunctions of a Team*

THANK YOU!



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Kaufman Fellows
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