How to Negotiate with VCs

by Deepak Malhotra

Summary.

VC–entrepreneur partnership agreements often contain flaws that become highly damaging as the parties come up against issues of power, trust, and much more. Yet many of the flaws are systematic and predictable—and hence preventable. The author, a long-time consultant to the VC industry, outlines four recommendations for entrepreneurs sitting down at the table with prospective funders.

Understand your leverage. Your leverage is not only a function of your alternatives; it has a lot to do with the VC's as well. Seek to understand them, and be prepared to educate the VC about why his exercising too much power could hurt *both* parties in the long term.

Maximize trust. Beneath all the financial projections, the VC negotiation is a process in which people are deciding whom they want to associate with for years to come. If the VC is vulnerable, use the opportunity to build trust rather than to take advantage.

Focus on value–not just valuation. Nonfinancial considerations such as control are also important.

Strive for understanding. Seemingly abstruse provisions can be highly consequential. And bear in mind that the choices a VC makes when negotiating can contain important clues about her assessments and expectations.

Above all, when you're negotiating with a VC, think not only about what will look good in a press release today but also about what will help you create and capture value over the long run.

A FEW YEARS AGO, a venture capital firm hired me to help one of its start-ups negotiate a critical deal. I expected the VC partner who was on the start-up's board to be deeply involved in the strategic discussions. But the VC in question—ordinarily a hands-on dealmaker—was conspicuously un involved. His advice and support would have been useful to the founders, especially with respect to opening doors with governments and potential partners overseas, so one day I asked him about his seeming lack of interest. He described the scene a year earlier, just after his firm had decided to invest in the start-up. "There was a lot of interest in this company, and the founders had a fair amount of leverage. They used every ounce of it to extract a higher valuation," he said. "We kept saying that our firm would bring a lot more to the table than money, and that the mentoring, strategic advice, network resources, and political capital we could offer were almost unmatched. The founders set all that aside and made it about the money. It left a bad taste in our mouth. The deal was still worth doing—barely. But we have less of an equity stake in the company than we would ordinarily want, and given all the other portfolio companies that need my attention, I don't feel any obligation or desire to give these guys additional assistance."

In retrospect, the entrepreneurs at the start-up made a costly mistake: Either they undervalued the nonmonetary resources the VC firm had to offer, or they assumed that mentoring and strategic support would inevitably be available. In either case, they negotiated a deal that looked great on day one but proved to be perilously misguided in hindsight. This happens more often, and in many more ways, than you might think—which is unfortunate, given how valuable and transformative a VC deal can be for entrepreneurs. Few business negotiations contain the degree of high stakes, uncertainty, and emotion present when company founders negotiate with venture capitalists. On the one hand, reaching agreement on a term sheet—the document that lays out how much equity and control a VC will have in return for its cash—is all about assigning rights, carving out protections, and haggling over claims to future returns. On the other hand, these negotiations are fundamentally about picking the right long-term partner and forging a relationship that can survive the inevitable disappointments, resolve the unforeseen conflicts, and monetize the mutually earned successes to come. I study negotiations in a wide range of circumstances and in recent years have taken a special interest in those between entrepreneurs and their strategic partners, including VCs. As a business school professor, I'm often asked for advice by students and alumni who are launching companies. And for many years I've consulted prominent VC firms, helping them and their portfolio companies with negotiations. These experiences provide a unique lens through which to observe deal-making successes and failures, and the stories in this article are taken from that work (the examples are anonymous, in order to pre serve confidentiality). One of the biggest lessons I've drawn from my work is that even skilled negotiators can make costly mistakes. In the pages that follow I'll describe some of those mistakes, exploring why they happen, what they can teach us, and how to avoid them. Before we begin, let me make three important points. First, this article is not the place to start learning the basics of negotiation, a broad topic on which there are many resources. Second, it does not attempt to introduce all the intricacies of the venture capital industry, which has its own language, protocols, and idiosyncrasies. Third, for any large or complex negotiation with a venture capitalist, you should consult a lawyer experienced in structuring VC deals. Term sheets can be difficult to understand, and you may need help determining what the various provisions—liquidation preference, antidilution protection, pay to play, drag along rights, vesting schedules, no-shop clauses, and so on—imply for your current and future rights and obligations. At the very least, you should contact other companies in the VC firm's portfolio to find out what was negotiable, why they made the choices they did, and what terms were the most consequential in the months and years after the deal.

Given the considerable resources, financial and otherwise, that a VC can bring to the table, these deals can be tremendous assets—but only if they're done well. That means, above all, thinking not just about what will look good in a press release today but also about what will help you create and capture value over the long run. Only with that mind-set can you strike a deal that takes full advantage of your leverage, build a relationship based on mutual trust, draft a contract that optimizes value (not just valuation), and reach a level of understanding that ensures that each party will be adequately rewarded for future success. Let's consider each element in turn.

1. Understand Your Leverage:

There are few things dealmakers worry about more than figuring out who has greater leverage and how best to use whatever power they have. It is surprising, then, that they so often ignore crucial sources of power or put themselves in unnecessarily weak positions. This is as true in VC negotiations as anywhere. One of the most obvious variables in any negotiation is the attractiveness of your alternatives to the deal. In the context of a potential VC deal, the more firms that are interested in your start-up, the more leverage you have. And although you should avoid squeezing long-term partners to their bottom dollar, as the start-up in the opening example did, you should certainly leverage your alternatives to fight for terms that are important to you.

Once the deal is signed, discarded alternatives will carry little weight, and any leverage you'll have going forward must come from other sources. Many entrepreneurs worry too much about the amount of power they have when negotiating the term sheet and too little about the amount they'll have after the deal is done. I recently worked with an early-stage tech company that discovered it would run out of cash in three or four months—much sooner than it had projected, and too early in the product development process. Its initial impulse was to solve the problem by fast- tracking a strategic partnership with a large company that would pay an up-front licensing fee for its technology. But it quickly became clear that it would be unwise to make such an arrangement before the company was further along with development, and so the start-up was forced to explore another round of VC financing. Perhaps because the start-up was running out of cash and had few options, the one VC firm that was interested offered a low valuation (that is, it would ascribe a low value to the company's current worth) and a big investment. The combination would have squeezed the founders' equity considerably. The CEO declined the offer and decided to pursue his third option: to ask for a bridge loan from his current VC. Bridge loans are often perceived as the "pay day loans" of the VC industry, a last resort form of short-term financing that generally carries onerous terms. This case was no different: Although sympathetic to the start-up's plight, the VC had to protect his own investment, and the loan would come with a significant dilution of management's equity.

The "running out of cash" problem is not uncommon. Founders often have too much confidence in their business model, too little ability to forecast their burn rate, and too little willingness to give up equity. As a result, they may fail to take in enough money during early rounds of funding. This start-up might have avoided the prospect of selling equity on the cheap if it had accepted more cash (and sold more equity) during the first round of financing—when it had numerous alternatives and could have commanded a better price. Many founders have discovered that doing a slightly bigger first round than seems necessary—or perhaps negotiating an acceptable formula for future bridge loans at the outset— can pay off in the long run: It's bad when you have few options, but considerably worse when you are running out of options and out of money. The story has an unexpectedly happy ending, one that contains another lesson on identifying and leveraging sources of power even when you're out of money and seemingly out of options as well. The CEO went back to the VC with a different approach, focusing less on his own desperation and more on the VC's interests. He made a simple but elegant case: "Yes, we screwed up, and you have the power to squeeze us on equity. But let's think about what will happen next. How many top people will stay if we dilute their equity positions? Is the premium you'll get worth the potential hit to management morale and firm success?" He persuaded the VC that forcing him to accept harsh terms could be a Pyrrhic victory, because an equity dilution could cause the start-up to falter or even fail, zeroing out the VC's investment. The VC agreed to provide the money, albeit in instalments tied to milestones, with no dilution of equity. This incident is a great illustration of how negotiators who wish to maximize their leverage need to avoid focusing too narrowly on their own options (or lack thereof) and should instead try to fully evaluate the other side's interests. In this case the CEO changed the discussion from whether the VC could leverage the start-up's weak position in order to meet short term goals to whether doing so would actually achieve the VC's ultimate goals. If you understand the other party's long-term interests and can find an approach that will serve them, you will have leverage even in the absence of attractive alternatives. Fundamentally, power in negotiation is about what you bring to the table that has value for the other side—which means you need to spend a fair amount of time understanding what the other side cares about, worries about, and hopes for.

2. Maximize Trust:

A successful serial entrepreneur told me about a day he spent agonizing over whether to call a VC with whom he was about to close a $10 million financing round. When he had pitched the VC, a month earlier, his business was gaining momentum, and he had laid out ambitious financial targets. Since then, however, a major strategic partnership suddenly seemed less secure, it appeared that the start-up's pricing strategy might not be working, and a key employee was on the verge of leaving. Although he had no legal obligation to reveal these developments before the close, he did feel a moral obligation, but he worried that the VC would change his offer or walk away from the deal. Finally, the entrepreneur picked up the phone. "This is either going to be the start of a very trusting relationship or the end of the dialogue between us," he said. He held nothing back as he shared the bad news. To his surprise, the VC reacted positively: He didn't pull the plug or try to renegotiate the terms. I later asked the VC why he chose not to factor the developments into the deal terms, as he surely would have had they been known at the start. "That type of phone call is not usually made," he said. "Usually after we make an investment, we wait for what we call the first 'Oh, s---' board meeting, where we learn about something that was not disclosed during the pitch.

The founder's full disclosure changed my perspective on him as a person more than it changed my perspective on the company or its prospects. To recut the deal would have reinforced the notion that he will be punished for delivering bad news." It's hard to overstate the extent to which VCs put a premium on trust—or the extent to which untrustworthy behavior can derail negotiations. Another VC told me about a founder with whom he'd been in conversations about a potential investment. The founder had made no secret of the fact that he was also in talks with another investor, saying he would prefer this relationship but wasn't ready to accept the current terms. The VC offered to make some significant concessions if that would seal the deal. The founder said it would, and the two men shook hands, agreeing that they had a deal. A few days later the VC learned that the founder was shopping the revised offer around.

The VC called him and told him the deal was off—he was no longer willing to invest in the company. Multiple apologies from the founder and numerous interventions from his board members failed to change the VC's mind. VCs expect you to ask for better terms, to comparison shop, and to use whatever leverage you have—but not after you have reached an agreement. It may seem obvious that this founder acted unwisely and unethically, but in the fevered pitch of deal making, even smart and well-intentioned people can lose sight of the fact that beneath all the term sheets and financial projections, the VC negotiation is a process in which people are deciding with whom they want to associate for years to come. In VC relationships, as in any long-term partnership, it's much easier to build trust than to rebuild it.

If you find you've settled on terms without sufficient consideration or have made commitments you cannot keep, you're better off playing it straight: "I think I may have agreed to something I'm not actually comfort able with." That will be an awkward conversation, and the VC may not be willing to reopen the discussion. But odds are you'll have a better outcome than if you renege on promises when they become costly or inconvenient. Venture capital is a small industry, and, as one entrepreneur puts it, "In my line of work, you don't have a CV. You just have your reputation."

3. Focus on Value: (Not Just Valuation)

In simple negotiations, focusing on a single, top-line number sometimes makes sense: If you're selling your house, for instance, you might not even meet the buyers, and despite issues such as inspections, financing contingencies, and the closing date, the selling price is far and away the top priority. In many other negotiations, though, the signed contract is just the beginning of a relationship. In these situations, it can be a mis take to focus too narrowly on price and not enough on drivers of long-term value. When negotiating a job offer, for example, people tend to obsess over the starting compensation, but factors such as geography, responsibilities, prospects for learning and advancement, and even length of commute can have a greater impact on their enduring happiness and success.

VC negotiations may exhibit the greatest disparity of any type of deal between how much people should focus on a single factor and how much they actually do focus on it. The factor that gets disproportionate attention is valuation. This is the metric that will be reported in TechCrunch, and it’s what your friends (and “frenemies”) will ask about when they take you out for drinks to celebrate the deal. But other terms may be far more important, especially if you hope to play a long-term role at the company. More than one VC has identified this short-sighted emphasis as founders’ biggest mistake. “They focus too much on valuation and not enough on control,” one VC told me. “It’s amazing how much control founders are willing to sacrifice in order to obtain a $4 million valuation instead of $3.5 million. These numbers don’t matter much in the long run, but the impact of diminished control can last forever.”

The tendency is especially remarkable when you consider the passion most founders have for what they are trying to create, for their company’s mission, and for their vision of its future. Once founders have sacrificed board control or ceded voting rights on too broad a category of decisions, those decisions are, of course, technically out of their hands. Most VCs are very reluctant to use their control rights to contravene the wishes and objectives of management, but if conflict or a breakdown in trust between management and the board occurs, founders may find themselves severely constrained, if not replaced. None of this means you should ignore valuation—it’s an important consideration. But it’s a mistake to confuse it with value, given that most founders also care a lot about factors such as their role, prestige, self-identity, and autonomy. To maximize valuation without regard for nonfinancial considerations is to sign something of a Faustian bargain.

4. Strive for Understanding:

Even when control is not the concern, you ought to pay close attention to terms other than valuation; there are additional pro visions that can have a huge impact on how much money you’ll eventually see. And if you look at them carefully, the terms a VC firm proposes can help you understand its unspoken concerns and assessments of your start-up’s future. Let’s consider an example involving two of the items often spelled out on a term sheet—liquidation preference and participation. Liquidation preference gives a VC firm the right, at the point of sale or at another liquidity event, to recoup its investment (or a set multiple of it) before the founder takes any return. Participation refers to whether the VC is entitled to a share of the value that remains once the liquidation preference has been paid out. Liquidation preferences are often set at one to two times the size of the investment, and participation can range from none to full. Imagine that a VC invests $2 million for a 20% stake in a start-up—implying a valuation of $10 million. She negotiates a 2x liquidation preference and full participation rights. This means that if the company is sold for $14 million, she’ll receive twice her investment ($4 million) plus 20% of the remaining $10 million ($2 million), for a total of $6 million. In other words, she’ll receive almost 43% of the sale price, even though her equity stake was only 20%. Note that the $10 million valuation in itself has little bearing on how the wealth is ultimately distributed. Even the same $2 million investment on a much lower valuation—say, $8 million—would hardly alter the final distribution; that figure would give the VC 46% of the sale price. It’s a stark reminder that if you focus only on valuation when you're negotiating a deal, you could be fighting for something that might not, at the end of the day, give you what you want.

Imagine that the same company is sold for $200 million. The VC again takes $4 million to cover the liquidation preference, but now that's a tiny percentage of the sale price; most of her return—$39.2 million of $43.2 million—comes from her full participation. And she gets only 21.6% of the sale price—much closer to the proportion of her equity stake. These scenarios show that liquidation preference, which is designed to protect a VC's up-front investment, tends to have a big impact on how much wealth is transferred to the VC if the company enjoys moderate success but has much less impact if the company performs spectacularly. If you think about these issues carefully during a negotiation, you will discover that a VC's preferences about such terms can reveal his interests and his assessment of a company's prospects. A VC who insists on enhancing the liquidation preference may believe that the valuation proposed by the founders is too high. The liquidation preference serves as an insurance policy that protects the VC's downside risk from founder overconfidence. Think of it this way: If a founder receives a high valuation in exchange for a high liquidation preference, the liquidation preference constitutes a side bet between the VC and the founder regarding whose expectations are more accurate. Participation is more like a lottery ticket than an insurance policy.

If a firm hits it big, participation gives the VC a huge windfall—so a VC who focuses on full participation may be projecting optimism about the start-up's eventual fortunes. A VC who focuses on board seats, voting rights, or other terms that define control may be less confident in the management team and is perhaps thinking ahead to when it will be replaced. There is nothing inherently wrong with any of these situations, but a careful understanding of the dynamics can help founders ask better questions, engage in a more productive dialogue about expectations, and ensure that they choose the right partner given their own goals. Many other terms warrant careful consideration in any VC negotiation, of course. My interest here is simply to emphasize the importance of understanding the consequences of seemingly abstruse provisions on the term sheet and to underscore how the choices a VC makes when negotiating it can serve as useful signals.

Lessons for Dealing with VCs:

1. VC attention and support are limited resources, and you'll be competing for them with other portfolio companies. A VC firm's willingness to spend time and political capital on you is a function of both its equity stake and its emotional stake in your company. You stand to lose if you negotiate these stakes down too low.

2. Beware of entrepreneurial overconfidence. When you're raising money, take into account the possibility that your progress will be slower than expected and that your business model will evolve. That may mean selling somewhat more equity up front than seems necessary, so that you can avoid negotiating for more cash later, when you have fewer options.

3. Your leverage is not only a function of your alternatives— it has just as much to do with the VC's alternatives. Having few options is not so terrible if the VC needs you to thrive. Seek to understand his interests and be prepared to educate him about why his exercising too much power could hurt both parties in the long term.

4. Transparency is often less costly than you fear. Experienced VCs have seen most problems before, and if you're honest about setbacks, they may have useful advice to share. Even if being transparent decreases your lever age, it will increase their trust in you—a trade-off worth making.

5. You can build trust most easily when the other party is vulnerable. It's when you could have exploited them but chose not to that other learn to trust you. If the VC is vulnerable, use the opportunity to build trust rather than to seek advantage. In a long-term relationship, trust built today enhances opportunities in the future.

6. Play it straight. If you're not in a position to make a commitment you can stick to, say so. If you have overcommitted, don't renege. Instead, own up to it quickly. The VC may be open to renegotiation if you have been forthright.

7. Beware the allure of valuation. Negotiate about all elements of interest to you, not just the investment level and equity dilution. Don't forget that you had many nonfinancial motives for becoming an entrepreneur.

8. Use your bargaining power wisely. Valuation and equity stake matter only if your company eventually succeeds— and if it does, other provisions could have a greater impact on your ultimate financial reward. Consider multiple scenarios for your firm's success and calculate what various terms would yield.

9. Pay close attention to which terms the VC accentuates in her demands. Her focus can reveal important information about her core concerns, underlying interests, and future plans for your firm.