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The Outlook for the Private Equity Market

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THE OUTLOOK FOR THE PRIVATE EQUITY MARKET

John C. McIlwraith[†]

INTRODUCTION

I joined Jones, Day, Reavis & Pogue in 1985 after graduating from Case Western Reserve University School of Law. I was interested in a corporate law practice with a focus on representing entrepreneurs and private businesses, areas that were well outside Jones Day's core practice areas at the time. In fact, I was advised that there was not a defined path to partnership in those areas and that I should get on a large public company "team" if I wanted to make partner down the road.

Nevertheless, I pursued the entrepreneurial path. My first client experience was with a small leveraged buyout group whose primary Jones Day lawyer was one of the two partners in the Cleveland office with an active private company practice. Fortunately for me, in the mid-1980s entrepreneurial business activity increased significantly in Cleveland and throughout the country, and I was one of the few lawyers at Jones Day active in the area. As a result, my client base grew rapidly and I enjoyed a diverse and challenging practice.

After several years of representing private companies and sources of private capital such as Primus Capital Fund, I concluded that I would rather be a principal in a private business or venture capital firm than a lawyer. But I recognized that having some real business experience would increase my chances of landing such a position. When Quantum Health Resources, a publicly traded healthcare company that had been venture-backed, asked me to join it as general counsel and head of its business development activities, I made the entrepreneurial decision to resign as a partner with Jones Day and gain the business experience I needed.

[†] Managing Director, Blue Chip Venture Company, Cincinnati, Ohio. This Article is an edited version of the presentation given by Mr. McIlwraith on November 10, 2000, at the George A. Leet Buisness Law Symposium at Case Western Reserve University School of Law.

Quantum provided me with great insight into what really goes on at a young, fast-growing public company. I was involved in all aspects of the company's interaction with investment bankers, analysts, and institutional shareholders. I was also in charge of the company's strategic investments in and acquisitions of private companies. The learning provided during my two years with Quantum is invaluable to me as a venture capitalist as I help companies grow their businesses.

Quantum was sold to a much larger company two years after I joined, and I became part of that company's senior management team. Within a few months after joining the larger company I decided it was time to join a venture capital firm or start my own. I spent the next few months considering a number of venture capital career alternatives.

In December 1996 I was introduced to Blue Chip Venture Company, a $44 million venture capital firm based in Cincinnati, by mutual friends. At the time, Blue Chip was seeking to add a third partner as they completed fundraising for a new $100 million fund. After one meeting with the two founding partners, during which we compared philosophies on investing in and building growth companies, they and I knew we would join forces. I joined Blue Chip two weeks later and we raised a $129 million fund. That fund was followed by a $235 million fund in 1999, and we now manage over $400 million of venture capital and have investments in over eighty-five companies.

Today I will provide you with a brief overview of the growth of the private equity industry over the past ten years. I will also discuss recent trends in the private equity market, the role of lawyers in the venture capital process, and the impact of these recent trends on lawyers and their clients.

I. HISTORICAL OVERVIEW OF PRIVATE EQUITY

There are basically two types of private equity transactions—leveraged buyouts, or LBOs, and venture capital investments. A typical LBO involves the acquisition of a mature company with a history of operations and earnings. In an LBO the investors usually own more than 50% of the company and control it. The investors often bring in one or more members of the management team to run the company, or back a team that identified the buyout opportunity.

In a venture capital transaction, the company is usually early-stage, meaning pre-revenue or with initial revenues but still twelve months or more away from profitability. The venture investors generally back an existing management team, which usually includes one or more of the company's founders. Venture investors, whether angels or institutional investors, typically own less than 50% of the company and do not control it. They do not want to have control of the company, except when the company falls well short of its projections and a change in management is necessary to keep the company afloat. Venture investors generally seek a higher rate of return on their investments than do LBO investors—a five to ten times return on their investment versus a three to five times return. This difference reflects the much higher degree of risk involved in a venture investment.

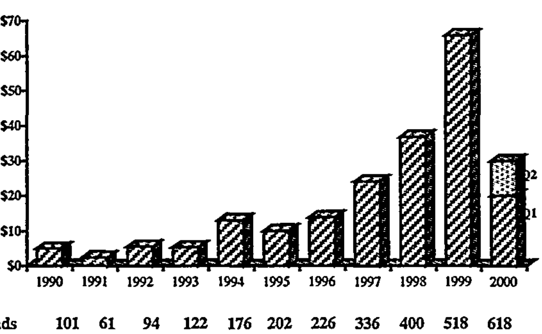
There are five sources of private equity capital: angels, incubators, private equity firms, strategic partners, and government programs. Angels include wealthy individuals—doctors, successful entrepreneurs, retired executives, and relatives. The institutional venture capital business largely developed as a result of the activities of angel investors in the 1940s and 1950s, beginning with members of the Rockefeller family.

In the last five years, angel investment activity has increased substantially as we experienced a seemingly never-ending series of successes in the public and private equity markets. There has also been a significant increase in the number of strategic investments made by large corporations, such as Intel, in early-stage private companies. A number of high profile incubators, such as CMGI, have been formed to take advantage of the attractive market for growing companies.

The amount of venture capital available for investment in private companies has grown dramatically since I began representing venture capital firms in the mid-1980s. As shown in Figure 1, the amount invested in funds has grown from $5 billion in 1990 to more than $60 billion in 1999, and the number of venture capital firms receiving funding has grown from approximately 100 to over 500.

Figure 1

Amount Invested in Venture Capital Funds (in Billions)



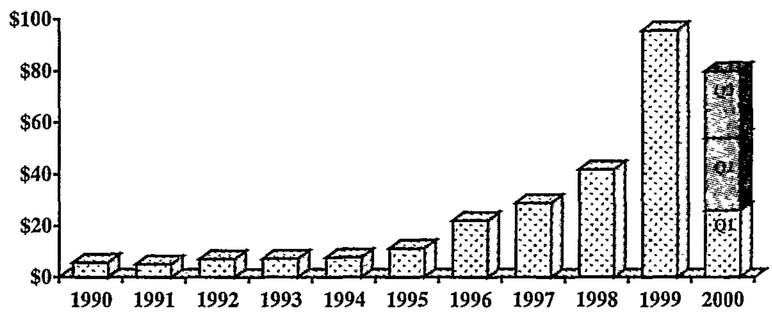
Source: *Venture Economics*/National Venture Capital Association (NVCA).

During this time the amount allocated by institutional investors, such as pension funds and endowments, to investments in venture capital funds grew from one to two percent of their assets to as much as ten percent. Individual investors also began to invest significant amounts in venture funds. These increases were driven largely by the high internal rates of return ("IRR") being reported by many venture funds, which in some cases exceeded 100% due to early investments in company's like Amazon, eBay, and eToys. However, the decline in the public stock markets and in technology and Internet stocks over the past nine months appears to have started to impact the amount of money being raised by venture funds.

The increase in the amount of venture capital available increased the amount of venture capital invested in companies, as shown in Figure 2. Further, as shown in Table 1, the scale of the increase resulted in a much larger number of companies being funded, an approximately three-fold increase since 1990. It also resulted in a significant increase in the average amount invested per company, from approximately $3.9 million in 1990 to $17.1 million in the first half of 2000. There can be no doubt—an enormous amount of capital has been chasing deals.

Figure 2

Amount Invested By Venture Capital Firms (in Billions)



Source: *Venture Economics*/NVCA.

Table 1

Number of Companies Invested in by Venture Capital Firms and Average Investment per Company

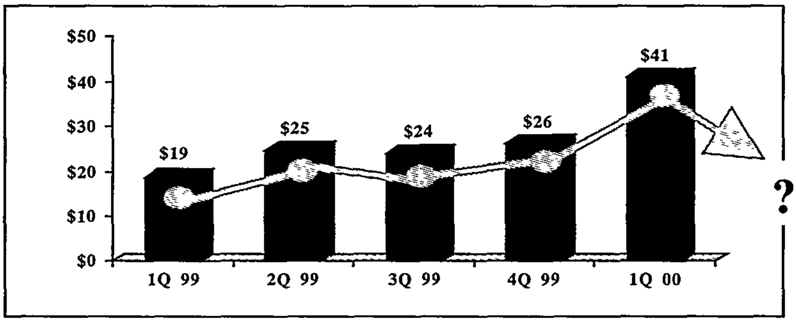
Year	Number of Companies	Average Investment per Company (in Millions)
1990	1481	$3.9
1991	1239	$4.2
1992	1452	$4.9
1993	1330	$5.5
1994	1418	$5.5
1995	1684	$6.7
1996	3088	$7.2
1997	3407	$8.5
1998	4034	$10.4
1999	5068	$18.9
2000	4685	$17.1

Source: *Venture Economics*/NVCA.

The amount of investment capital available from venture funds, combined with a large increase in competition for investments from angel and strategic investors and incubators, has driven the valuations of early-stage companies seeking growth capital to extraordinary levels. As Figure 3 reflects, the median pre-money valuation for companies—the value that determines how much of the company the investor receives for its investment—has doubled from the beginning of 1999 to the beginning of 2000. Amazingly, the first quarter 1999 number was probably two to three times what it was in 1990.

Figure 3

Median Pre-Money Valuations (in Millions)
First Quarter 1999–First Quarter 2000



At these valuations, a company will need to be worth several hundred million dollars at the time the venture fund achieves "liquidity" on its investment, through an IPO or sale of the company, in order for the venture fund to earn an attractive rate of return. Considering that many of these companies have little if any revenues and no earnings at the time of investment, achieving such a return is no easy matter.

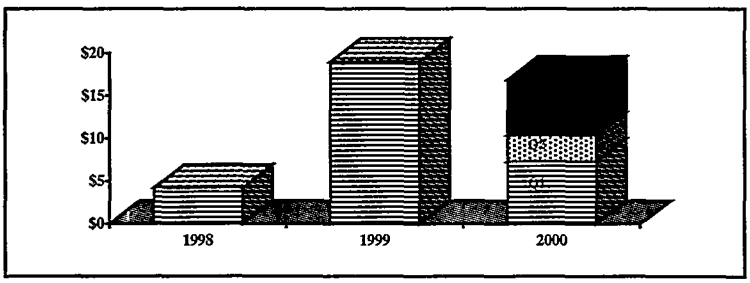
At Blue Chip, we have had several early-stage companies seek financing from our firm that expected pre-money valuations of $25 million or more with little or no revenues, no real proof of concept, and, in some cases, a mediocre and inexperienced management team. We have seen multiple companies pursue nearly identical business strategies, such as buying life insurance on-line. Often, these companies had received an initial round of financing from angel investors who valued the company at an unreasonably high level by traditional measures. Despite the good feelings experienced by the management team as a result of these valuation levels, they created unreasonable expectations on the part of the management team and the investors and made future financing rounds more difficult.

The significant increase in the levels of the public stock markets and the post-IPO valuations of venture-backed early-stage companies over the past three years, which in many cases exceeded $1 billion, has further fueled unrealistic expectations on the part of entrepreneurs. The amount of venture capital available for investment and the competition for attractive investment opportunities from multiple sources resulted in such expectations often being fulfilled. But with the pace of IPOs slowing, as shown in Figure 4, pre-money valuations for private companies should start to decline as venture funds conclude they will have to wait longer than twelve to twenty-four months to achieve liquidity on their investments and that the value of the company at liquidity will be much lower.

The competition for investments affected more than valuations. As Figure 5 reflects, the pace at which investments were completed also increased over the past decade. In the 1980s and early 1990s, the period of time from the initial meeting between the venture fund and the private company to the closing of the investment was three to five months, depending on the amount of due diligence required and how fast the lawyers moved. In 1999, based on our direct experience and observations of others, the average investment took approximately forty-five days to complete after the initial meeting. Some investments closed within weeks after the initial meeting. However, the downturn in the public markets and the increasing feeling that the "bubble" might have burst, has resulted in a return to a more traditional time frame for the venture capital investment process.

Figure 4

Pace of Venture Backed IPOs (in Billions)

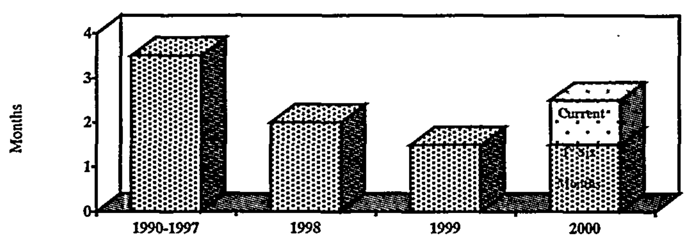


# of Cos.	77	248	177

Source: *Venture One.*

Figure 5

Venture Capital Investment Process
Time from First Meeting to Closing



II. CURRENT PRIVATE EQUITY TRENDS

As I previously noted, the downturn in the public equity markets and the slowing of the number of IPOs being consummated over the past nine months has had a noticeable effect on the private equity markets. As a result, there will likely be changes in many aspects of the private equity investment process, from the role of the venture capitalist and the sources of private equity, to the form of the investment documents for a transaction and the role of the lawyer in the process.

From 1997 through 1999, the free flow of private equity capital from multiple sources and the apparent ease of going from start-up stage to IPO, even before proving the business model, caused entrepreneurs to change their approach to raising equity capital. Instead of seeking out investors who would add value to the process of building the entrepreneur's business beyond the capital, entrepreneurs sought one thing—a high valuation for their companies regardless of the source of the capital. As a result, companies often received funding from: angel investors who offered only capital and a high valuation; strategic investors who offered capital and a high valuation, but often attached strings relating to business relationships and rights; and newly-formed venture capital firms whose partners had little experience in helping build young, high-risk enterprises.

In many cases the companies being funded had a questionable, or at least unproven, business model. Many "pure play" dot-com companies were in this category. Business strategies tied to "monetizing eyeballs" and business-to-business exchanges that would "disrupt" the natural order of business relationships were the rage. Traditional business rules were ignored, and companies pursued their strategies with incredible rates of spending or "cash burn," fueled by a seemingly unending supply of private, and sometimes public, capital. An IPO was a foregone conclusion in the eyes of many entrepreneurs and their investors.

The short time to IPO or other liquidity events for venture-backed companies also changed the behavior of venture capital firms. They made investments in a larger number of companies per partner since less work was required to build the companies and achieve follow-on rounds of financing or liquidity. They also began limiting the amount of the investment round that they would syndicate, or share, with other venture funds. In many cases venture funds "loaded-up" on what they considered to be a good deal. Finally, venture funds softened the terms of their investments and the investment documents. They were so worried about losing an investment to the competition that they waived traditional terms giving them a degree of control if the company became troubled. We even saw examples of a "lead steer/herd" phenomenon, where venture funds rushed to join a lead investor in a hot deal with little regard to conducting due diligence on the company's business model and management team.

Recently, companies and investors are learning how fast things change. Angel investors are pulling back from "committed" investments as the value of their public stock portfolios shrinks. At the same time strategic investors, such as Intel and MarchFIRST, have slowed the flow of investments into private companies as the period of time required to achieve liquidity increases substantially and their core businesses are adversely impacted by the market downturn. The pace of IPOs has slowed, and early-stage companies with little or no proof of a sustainable business strategy are finding no interest from the public markets. Private companies are struggling to grow, or even stay in business, as planned later round financings take much longer to consummate and angel and strategic investors refuse to provide the "bridge" financing necessary to allow continued growth until the next round closes. Management teams are being "forced" to build a real business, and investors have to work hard with management to create value and earn a return.

At the same time, venture funds appear to be paralyzed and confused as they consider new investment opportunities while trying to save companies in their current portfolio that are running out of money pursuing a questionable business model. Companies are finding that investment terms and documents have gotten much tougher, and that venture funds are in no particular hurry to close new investments. Venture funds are returning to basics, seeking to invest in businesses with early proof of a viable business model and customers and to co-invest with one or more firms in a financing round.

We have seen several painful examples in the public markets of the change in investor sentiment. Once high-flying public companies that were venture-backed and have not proven their business model have seen their share price drop to as little as ten percent of the high. Drugstore.com, Healtheon, and Pets.com, and public incubator CMGI, are prime examples.

Pets.com is a great example of the excesses of the past two years. The company was formed in February 1999 and raised approximately $110 million of venture capital through four rounds over eight months. The company went public in March 2000, fourteen months after its formation, and had a $300 million market capitalization. It generated $150 million in operating losses through June 2000, including spending $25 million on Super Bowl ads. Today the company is out of business, having failed to convince people to buy dog food and other pet products online. The venture fund investors lost their entire investment, unable to cash-out in the months after the IPO.

III. THE LAWYER'S ROLE IN THE INVESTMENT PROCESS

In a typical venture capital investment transaction the lawyers have three basic roles: (1) assisting their respective clients (the company and the investors) with the outline of the key terms of the investment, usually through the negotiation of a term sheet; (2) drafting or reviewing and commenting on the investment agreements containing the agreed-upon terms; and (3) conducting legal due diligence on matters such as the company's capitalization, governance documents, and material contracts. Although the length of the documents and the "side" they favor ebbs and flows with the market, there are almost always four basic agreements: a stock purchase agreement, which sets forth the terms of the purchase of shares and contains representations, warranties, and covenants of the company and the investors; a shareholders agreement, which contains provisions providing for board of directors representation and share transfer restrictions; an amendment to the company's articles or certificate of incorporation, which contains the terms of the preferred stock being purchased; and a registration rights agreement, which contains provisions with respect to the future public offering and sale of the shares purchased by the investor.

In most cases these documents, while heavily negotiated by the lawyers, will never be looked at again after the closing unless the management team and the venture capitalists become adversaries over the progress or direction of the business or over how the value created should be shared at the time of an IPO or sale of the company. That being said, they require special attention by the lawyers up front. Counsel for the investors needs to not only make sure the agreements contain the agreed upon terms, but must also tailor his or her "form" agreements to the company and its business. For example, if it's a technology company, the representations and warranties should include a focus on intellectual propriety rights and ownership. Too often the agreements remain in their "form" state failing to cover the matters most important to the investor, but including provisions that are irrelevant (e.g., an extensive environmental representation when the company is a technology consulting firm located on the twentieth floor of a downtown office building).

The negotiation of the investment documents is often the most difficult and stress-producing part of the transaction, particularly when one of the party's lawyers has little experience dealing with "standard" venture capital investment documents. Lawyers frequently argue endlessly over provisions that, over the life of the investment, will have little relevance to the success of the company or the investment. Often the clients—the venture capitalist and the CEO of the young company—are drawn into the argument with no real appreciation for whether the argument is worth having. By the time of closing the parties have lost the feeling of partnership that was created at the moment the letter of intent or term sheet was signed. The tension created adversely affects the ability of the management team to make the best use of its newfound capital and of the investors to help management build the business.

A good lawyer can make a big difference in how efficiently and smoothly a venture capital investment transaction is consummated. Rather than competing with the other side's lawyer regarding a finer point in the standard two to three page employee benefits plan representation, the lawyer should spend time with his client to determine what matters are really important and negotiate with these matters in mind. If the lawyer is representing the investor, he or she might determine what aspects of the company's business creates the value that has the investor excited (e.g., proprietary software) and then make sure the agreements contain relevant provisions. If the lawyer is representing the company, the focus might be on the investor's ability to control the company or dictate the terms of future financings through covenants.

Each side's lawyer should discuss with his client the various provisions in the documents, their purpose and the likely points of tension during the upcoming negotiations. It may also be desirable for company counsel to proactively review with the client whether it has alternatives if the venture financing is unsuccessful, either because of a breakdown in the negotiations over the agreements (rare) or a change in the markets or the venture capitalist's focus or thinking while the investment documents are being negotiated (more common).

When reviewing a pending investment transaction with Blue Chip's counsel I ask him or her to: (1) make the investment documents consistent with the term sheet; (2) focus the representations and warranties on the areas that are specific to the company's business; (3) conduct a basic negotiation of the documents with the company's counsel, being as practical as possible, and provide me with a short list of the issues I should care about; (4) provide me with practical guidance and solutions on those issues; and (5) do everything he or she can to cause our new partner, the company's management team, to think well of Blue Chip and, most of all, not kill the deal. The same request should be made of company counsel.

The "new economy" and the use of the Internet in the private equity process will create new challenges for lawyers. We are already seeing widespread dissemination of "private" placement memoranda for financings via e-mail, in many cases in clear violation of the "no public offering" restrictions imposed by the private placement exemptions under the Securities Act of 1933. The number of investments made by "under"-sophisticated angel investors in extremely high-risk, very early-stage companies is staggering. In many cases the angel cannot properly assess the company's real potential and the risks involved. Nor are they aware of how long, and how much more capital and work, it will take to achieve a liquidity event. Many of these investors will be disappointed and may seek recourse from the company, other investors, or even the company's professional service providers. They may also be difficult to deal with as the company attempts to raise additional capital on terms that adversely impact the angels.

We are also seeing "Internet age" projections—projections that suggest the company will grow from no revenues to several hundred million dollars of revenues in four to five years. In many cases the assumptions underlying these projections have no basis in reality or history. They are simply what the company's management determined would need to be shown to raise money at the desired valuation level. Even if the company's failure to meet the projections is not legally actionable, they create unreasonable expectations on the part of investors and new employees.

IV. POSSIBLE IMPACT OF CURRENT TRENDS AND RECOMMENDATIONS FOR COMPANIES

The correction in the public markets and apparent trends in the private equity markets will likely lead to a slowdown in the number and pace of venture financings. Marginal companies—very early-stage with little proof of concept for their business strategies—will have trouble finding private equity capital. Companies that have completed first round financings may find it difficult to close "planned" second round financings on schedule, making bridge financing from current investors a necessity.

As private company valuations decline, sometimes more than fifty percent below the last financing round level, companies will face serious difficulties in consummating subsequent financing rounds as earlier investors seek to protect their positions through anti-dilution provisions or threats of legal action. Capital structure difficulties may scare away future investors who do not want to get entangled in a dispute between the company and earlier round investors. Companies that lack experienced, deep-pocketed venture fund investors may not be able to "bridge" the financing gaps and continue building their business.

Companies are also finding that the once hot industry segments are of no interest to private equity sources. Business-to-consumer strategies, and even business-to-business strategies, are out of favor, affecting the availability of future financing rounds and the timing or viability of liquidity events for companies in those markets. The margin for error in business strategies and financing plans is very small, requiring real focus from management, investors, and boards of directors.

What should companies do to minimize the adverse impact of these private equity market trends? I have a few recommendations that are appropriate for today and have been proven over time:

Accept more money than the budget requires. Markets change rapidly, as do sales projections. Companies should always consider taking more money that the budget suggests is required. We have rarely seen companies hit sales projections, and the expenses of growing a young company always seem to be higher than planned. Although taking more money results in greater dilution to founders and management, that dilution will matter little if the company is successful, and will definitely not matter if the company fails. And you never know when we will experience a market like the one we are facing now, where even good companies are struggling to raise more capital.

Choose equity partners wisely. Even in the current market companies will have choices. Angels and strategic investors are still somewhat active. Companies need to choose their equity partners wisely, considering the depth of the investors' resources and whether the assistance that a venture fund can provide in the process of building a company is important. Companies also need to consider the chemistry between management and the investors and among the co-investors, if applicable. During tough times, which virtually always occur over the five years it takes to build a company, these relationships will be critical to keeping the company on track with minimal distractions.

Build a real company. During the past few years many companies focused almost exclusively on the exit, such as an IPO or strategic sale, or on the next financing round, rather than focusing on near-term business-building matters and proving the business strategy is viable. Management teams and investors were focused on getting rich quick. They forgot that, absent the assistance of blind luck, the way to create value is to build a high-growth, profitable enterprise. There is no such thing as easy money, even in the venture capital business.

The recent trends will likely create additional challenges for lawyers representing venture funds and venture-backed private companies. Companies that have raised rounds of financing from diverse investors at high valuations will face difficulties if they need to raise more capital in a "down round." Investment agreements will be tested. Agreements that were rushed and not reviewed carefully may not work in the way one or more of the parties expected. Lawyers who are aware of a client's need for a near-term financing should proactively consider how the terms of outstanding preferred stock or investment agreements will impact the financing.

CONCLUSION

The "hangover" produced by the excesses of the past few years will undoubtedly create challenges for private companies and private equity investors over the next few years. But the historical track record of the private equity industry and the never-ending efforts of entrepreneurs to build companies will cause the private equity market to survive and thrive for years to come.