Ten things strategic investors should consider when investing in startups

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As strategic investors continue to better understand the venture capital (VC) ecosystem and build collaborative investment partnerships, they have experienced a broader acceptance in the VC world. Today, they are an important part of the innovation and growth strategy for startups across nearly all industries.

Strategic investments

Traditional VC funds invest using capital raised from external investors. Strategic investors, known as corporate venture capital (CVC), are usually a department or a separate subsidiary of a large operating company. A CVC invests directly from the company's balance sheet, usually in a startup operating in the same or a complimentary industry.

CVCs tend not to invest at the seed stage and instead at a later round. Although it is difficult for a CVC to justify itself to its parent corporation without compelling financial returns, the case for a CVC fund transcends mere financial profits. There are many strategic objectives driving their investments: direct access to new innovations, support for their own internal innovation program, help building a business development pipeline and the ability to monitor industry trends in technology. Other powerful strategic motivators are the branding and marketing benefits that accrue to the CVC's parent company by entering into a partnership with an exciting startup building a promising technology.

These strategic objectives have propelled CVC funds to become a critical part of the startup ecosystem. In 2018, their investments accounted for 52.7% of total VC deal value in the U.S. and 17.1% of all U.S. VC deals. CVCs participated in 23% of all VC deals throughout 2018, amounting to 2,790 global deals worth $53 billion, which is an increase of three percentage points since 2017 and seven percentage points since 2013.[1]

Growing influence

The data shows that CVCs are a growing influence. The "2019 Global CBC Report" found 264 newly active CVC firms invested for the first time in 2018, amounting to a 35% increase in new firms compared to 2017. A total of 773 CVCs were active throughout 2018. The success of CVC groups is evidence they have gained greater traction and influence within their parent companies, leading to broader strategies and more (and larger) transactions.

The success of CVCs is also potentially fueled by the fact that, as the problems startups are attempting to solve get more complicated, industry partners become more valuable for the knowledge and experience that they bring to a young startup. For example, a startup using AI to develop new drugs may benefit from an investment by and commercial relationship with, a major pharmaceutical company.

When driving these investments forward, there are some important things to keep in mind.

1. **Play by the traditional VC rules/terms**. It is important for a CVC to understand the market terms and practices of traditional VCs. The success of the VC ecosystem is due in part to the standardization of financing terms, which lowers transaction costs and ensures deal flow for funds. As a result, successful CVCs generally participate on the same customary terms and conditions as traditional VC investors. This is particularly important to note for CVCs that are supported by an internal M&A or private equity legal team. It means that if you're engaging external counsel to help with the investment, it should be a lawyer with direct VC financing experience so that they are aware of the standard VC documents and market terms. As mentioned above, the present success of CVCs is in part due to their increasing willingness to largely play by the rules of traditional VC investments.

2. **Beware of board conflicts of interest**. It is typical for a lead investor to take a seat on the startup's board of directors. For strategic investors, this of course raises a potential conflict of interest. This is especially true in the context of an acquisition by an industry competitor of the CVC. On the one hand, an investor nominee has a fiduciary duty to do what's best for the startup, which typically means getting the most value for its shareholders. On the other hand, the investor nominee is usually a member of the CVC's executive team, which might have other motives (such as preventing a competitor from acquiring the startup and its technology).

   These conflicts can of course be managed with proper governance rules and procedures in place. To avoid the conflict of interest in the first place, some strategic investors opt instead to hold a board observer seat (which involves the right to attend all board meetings and receive all director information, but no voting rights). This helps mitigate future conflicts but still gives the strategic investor visibility into their investment's progress and the startup's activities.

3. **Deal with confidentiality issues upfront**. As noted, a CVC's director nominee will typically be a part of the executive team of its parent company. Such director might receive confidential or proprietary information about the startup that the director might be tempted to share with the management team of his employer. It is prudent to negotiate a standalone confidentiality agreement that clearly defines what is and is not confidential information and a process for dealing with the flow of information that does not fit in those binary categories.

4. **Ask for the information and data you want**. It is typical for large investors to receive regular information about the performance of the startup. That information typically includes things like quarterly and annual financial statements (most likely unaudited in the startup's early days), a business plan, annual budgets and notice of material litigation. CVCs, however, might want to ask for additional information that is uniquely helpful to them (these rights are usually put into a side letter). Consider whether there are key industry or product specific metrics that your CVC would want to review regularly. For example, an automobile manufacturer investing in a robotics startup may want to receive specific performance metrics on how a prototype robotic arm performs certain tasks.

5. **Must have exclusions in drag along rights**. Drag along rights are a standard term in most VC deals because they facilitate sales of the company to a third party. It allows a collection of majority shareholders to force minority shareholders to sell their shares but on the same terms and conditions as the third party is offering to the majority shareholders. CVCs must be particularly careful when negotiating drag along rights (because they can be dragged into a sale by the terms). For example, they should specify that they won't be subject to any restrictive covenants. Most importantly, that they will not be required to sign a non-compete with the third-party purchaser given that the parent company of the CVC may be a competitor of the third-party purchaser.

6. **Reconsider the right of first refusal**. Given their monetary contribution and investment in the commercial relationship, a strategic investor might be tempted to ask for a right of first refusal on an eventual sale of the company. This right gives the holder the ultimate authority to acquire the target over any other third party by matching such third party's offer. This is particularly tempting where the CVC invests in a startup whose technology has the potential to entirely disrupt the industry in which the CVC parent company operates. However, strategic investors should think carefully before insisting on a ROFR because they could discourage third party bidders, complicate the sale process and possibly depress the potential sale price.

As a result, other investors and directors usually do not like this term. Furthermore, if added early in the lifecycle of a startup, a ROFR can have a chilling effect on future investment in the startup and can hamper its growth. There are less controversial alternatives: for example, a right of first offer gives the strategic investor the right to submit an offer and have the company negotiate in good faith but falls short of the effective veto right that a right of first refusal carries. A right of first notice—which requires the company to merely give the strategic investor notice that it has received a term sheet for its acquisition—simply gives a CVC time to respond to a potential third-party acquisition but gives no further guaranteed rights to participate in the sale process.

7. **Special pre-emptive rights**. Pre-emptive rights allow investors to invest their pro-rata share in the startup's future financing rounds. Practically, however, the lead investor of the follow-on round will set how much they want to invest in the round and set aside a pool of money for existing investors to allocate amongst themselves. Since smart investors recognize it's in everyone's interest to accept the new money (which is often coming from investors that can cut bigger checks), this is the generally acceptable process. Sometimes a strategic investor asks for a special pre-emptive right, allowing them to take up the entire follow-on financing. Like the ROFR discussed above, the mere inclusion of this right can have a chilling effect on future investments.

8. **License exclusivity is probably not the answer**. If the strategic investor's deal with the company includes a license for the company's technology, it almost always should not be on an exclusive basis. If it is exclusive, then the parties should agree that the most likely exit outcome of the investment relationship is an outright acquisition by the strategic investor. Instead, consider asking for a limited period of exclusivity or simply negotiating a discount on the software license or subscription as a reward for being an early believer in the product and the startup's team. This reward could take the form of a most favoured customer clause in the commercial arrangement.

9. **Think about how to allocate IP rights**. The commercial agreement between a CVC and startup is often a cornerstone of the deal. Parties must put a lot of thought up front about how to properly allocate IP rights. What does each party contribute to the IP? Who owns what's in the IP? Does the startup own all of it, but grants a license to the strategic investor? If so, what's the scope of that license? Is the license term limited? Does the license terminate upon sale to a third party? These commercial terms will be heavily negotiated by the parties.

10. **Retraction rights as escape chutes**. Strategic investors are very sensitive to reputational harm and are sometimes operating in regulated industries. So, a strategic investor might want to quickly get out of an investment in a startup that is making the news for the wrong reasons or is catching the ire of a regulator. The easiest way to exit in a hurry is to negotiate a retraction right (effectively a put right). This gives the strategic investor the right to put its shares to the company for a nominal amount (e.g., $1). Given the relative size of the investment, a strategic investor may be more willing to cut its losses than to face reputational or regulatory risk through its continued investment in the startup.

The above discussion is intended to highlight some of the salient issues strategic investors should consider. However, the approach taken in each case will partially depend on the CVC's thesis and objectives for the investment.

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[1] "2019 Global CBC Report".