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5 things founders should know about investors

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First-time entrepreneurs often find themselves in over their heads while negotiating with angels investors or VCs, who have more experience and money

MUMBAI: There is always a gap between what an investor thinks is fair — whether the terms of funding or valuation — and what a founder thinks he ought to get. Founders, especially first time entrepreneurs, can find negotiations with angel investors and early stage ventures challenging.

So, founders need to do their homework and be prepared for what will come up during discussions. "Being street-smart is vital," says a founder of an e-learning portal. He narrates that a potential angel investor wanted his startup to pay for the cost of due diligence (including travel and stay). Wiser from this experience, the founder advocates doing a background check of individual investors or better yet, pitching to reputed angel groups. "Two or more members of an angel group pool their money, which means more funds. Plus they bring diverse expertise to the table, which is a value add for any startup," he adds.

Anjana Vivek, founder director of VentureBean Consulting, says founders should choose their first investors wisely. "Investors are not out to cheat gullible founders, but they do have the money power, knowledge and experience. In their eagerness for funds, founders must not ignore the fine print. After all, the first valuation impacts subsequent ones or giving up wide-ranging decision making rights can be detrimental," she says.

Negotiations result in drawing up of the term sheet, a document outlining the terms under which an investor will provide funds, and it is a blueprint for the legal agreements that follow. Angel investors are more flexible whereas venture capital firms tend to stick to standard clauses.

1. PERSONAL LIABILITY

"In early stage companies, investors usually ask for a personal indemnity from the founders. As the rounds of investment progress, founders should try and limit their liability and only provide for indemnity from the company," says Kartik Maheshwari, who leads startup practice at Nishith Desai Associates.

2. BOARD MEMBERSHIP

Investors' board representation should be limited to one or two investors and their voting rights must be proportionate to their shareholding. "We had the misfortune of having three investor representatives on our board, who didn't agree on appointment of a key hire and sent us in different directions for product diversification. Ultimately this venture floundered," recalls a former entrepreneur.

"It's fair and reasonable that during each of the funding rounds, the lead investor has the right to appoint a director. The second largest investor can appoint a board observer. At times, there are two equal or near equal investors and both may be offered the right to appoint a director. As a company grows and existing investors dilute below a certain threshold limit, their right to appoint directors should fall. We do give up our board seat when we cease to be the largest or second largest investor. We also ensure that our representative director votes in the best interest of the company," says Ashish Fafadia, CFO, Blume Ventures, an early stage VC fund. "From a confidentiality perspective, founders could also request that such a director not be on the board of a competitor," adds Maheshwari.

3. AFFIRMATIVE VOTING

This clause ensures that a startup can proceed with a particular course of action only after the investor's approval. Alok Mittal, co-founder of Indifi Technologies and a founding board member of Indian Angel Network, says: "Affirmative voting should be limited to certain issues only, such as amendment of business objectives, or issues relating to capital or key management personnel."

Ganapathy Subramanian, serial entrepreneur and former VC, adds, "Founders must ensure that this clause is not ambiguous. They could also negotiate that if the investors don't act on their affirmative vote, it would be regarded as consent."

4. SHARE CAPITAL

As investors want founders to have their skin in the game, a lock-in period of up to five years, for all or a significant portion of shareholding, is typically prescribed. Post this, founders can sell minor stakes. Fafadia says he prefers having vesting clauses for founders — terms that give the company the right to purchase a percentage of a founder's equity if he or she decides to walk away. "This clause doesn't hurt founders but helps align incentives at all levels," he says, explaining with the hypothesis of one of three founders who owns 25% of the shares quitting a company after two years. The startup loses a key stakeholder, a replacement needs to be found and adjustments made. "Thus, it's fair that the outgoing founder leaves half of his shares that can be used, say, to hire a new senior team member. We provide a clause where shares vest over a period of four to five years, depending on the stage of the startup and the track record of the founding team," he explains.

Generally, investors ask for the right of first refusal (ROFR). Here, if founders get an external offer at x price, they have to ask the investor to match it. Only if the investor refuses can these shares be sold to the external party.

If ROFR exists, third parties find it less attractive to negotiate a purchase, as it's possible that the existing investors will scuttle the deal. "As ROFR adversely binds the founders, instead a right of first offer (ROFO) may be given if insisted upon. Under an ROFO, the investor makes an offer at x price, but the founders have the option to sell the shares to another party at a higher price," explains Mittal.

5. EXIT CLAUSES

A liquidity preference clause ensures that investors get first preference over distribution of the assets on liquidation. A simple 1x-1.5x return is typically sought. Even where the business is up and running, an investor's ultimate objective is exit via an IPO or strategic sale. If an exit by these means is not possible, investor agreements typically require the startup to buy back the shares from the investor at a price that delivers a guaranteed internal rate of return to the investors. All exit clauses need to be vetted carefully.