March 15, 2019

Startup Investment Plan Pivots: Opportunities and Dangers for Smaller Investors

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In my last article, I posited that smaller risk capital investors outside the significant venture capital centers should avoid the grand slam venture investing model with its emphasis on finding the next Unicorn. Instead, they should focus on "small ball" investment plans that harken back to the early days of venture capital, when funds, investment rounds, and exits were typically a very small fraction of the headline deals in the business today. The classic "company building" investment plan with its focus on capital efficiency and profitability over capital intensity and growth.

Of course, business plans inevitably morph between the startup round and the exit transaction. Some, probably most, small ball business plan pivots have marginal rather than foundational investment plan implications. But now and again, a business plan pivot will take a small ball portfolio company down the Unicorn road. And when that happens, it can be a real challenge for an incumbent small ball investor to get a handle on what the pivot means for their investment, and what they should do about it.

Pivoting from a capital efficient, cash flow based exit to a more capital intensive, growth based exit, might turn an early investor's home run bet into a grand slam. It happens. At the point of the pivot though, the smart incumbent small ball investor will look in the mirror and do some soul searching as to her options, which usually included doubling down or holding, but often include an opportunity to cash out.

The decision to fold, hold, or double down in a homerun to grand slam investment plan pivot can be vexing for a startup's pre-pivot investors, particularly if as is often the case they have some control – through the Board, or voting rights or negative covenants – over the company's business model pivot. (Fiduciary and operational considerations can, in some situations, trump even seemingly very powerful legal rights. See my previous post, Who Do Directors Represent?)

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Too many early investors, in my experience, avoid the issue either by doubling down as a matter of course because they have the dry powder allocated for the deal, or holding because they don't, and exploring the cash-out question only if the new investors bring it up. What they should do is take an objective look at the new business plan for the company, including how it impacts the investment plan, and make a de novo investment decision, including whether to proactively investigate a cash-out scenario.

Now, it's true enough that in a routine follow on round, where the "new" business plan is consistent with the original investment plan, there is a good argument for a presumption of participation (assuming dry powder is on hand; the original investment thesis intact; and portfolio triage considerations are not in play). But when a business plan pivot from home run to grand slam implies a corresponding investment plan pivot the existing investors should treat the prospective investment for what it is: a fundamentally different risk/reward profile with an added element of financial risk and a three-part analysis that includes (unlike the initial investment) a possible exit opportunity.

In these situations, I've argued elsewhere that cashing-out seldom makes much sense. While my argument on that score was sound, it was perhaps too dogmatic. It more or less assumed that the "will this deal work" analysis of the original deal remains intact moving forward – with the new, higher expectations of what "working" means. (Note, however, that the new investment round, and any subsequent rounds, will likely include exit preferences for the later investors that would eat up at least a substantial portion of any exit proceeds from a smaller exit – even one that would have made the deal work in terms of the original financial model.)

A ground up investment analysis is of course a lot of work, all the more so if it takes an investor out of their comfort zone in terms of the financial model for the deal. Personally, I might short-circuit it based on my confidence in the new lead investor: if it's a widely admired industry stalwart, well, if nothing else it would be hard to explain to my limiteds if I passed. And, while no VC likes to admit it, most followers in deals often look to the lead for the heavy lifting on the due diligence in any event. (And even if the deal ultimately craters, my limiteds will probably give me a pass for following a name brand into the deal.)

Alas, the new grand slam lead investor isn't usually a Sequoia-class fund. Rather, you need to actually do the work and make a "lead-like" investment analysis – at least as to the financial risk factor - even as you are in fact making a "follow (or not) the leader" investment decision. An investment analysis that should include at least exploring with the new lead and other investors if cashing-out (selling all or some of your stake) to one or more of them is an option.

Investment plan pivots happen. Most of the time, they come via a business plan pivot coupled with the prospect of a much larger than anticipated next round of financing. They are hard for pre-pivot investors to miss if they are paying any attention at all to what their portfolio companies are up to. When they do happen, those prior investors should take a good hard look at whether – whatever the merits of the business plan pivot – the investment plan pivot is one they should jump on, board with, or bail on, or just ride out the storm.

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