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1:27 PM

Case Study:

A Portfolio Manager tries to figure out if one of his opportunities is a fit with the VMS fund

Elevator pitch from the PM and the VMS Ventures response (in blue).

We are building a collaboration tool that has the potential to become the Atlassian or Sketch of our industry. It is a big vision.

Current revenues are ~\$35K/year. We are charging our existing customers ~\$500/seat/year to use the product. We have 1-2 offshore resources doing development with 10-15% of a product manager providing them with direction.

We would like to switch to a freemium model for the tool, and to add more development resources to see if we can catalyse viral adoption throughout the industry. We foresee 2-3 years of investment before any meaningful revenue, but we expect rapidly increasing usage metrics will show us whether this is working or not.

On the upside, the market for 'users' of this product is substantially larger than our current market. I could probably convince myself that the market size is \$500M-\$1BN. Unfortunately, that also means that there could be well-funded new entrants.

This is an ideal stage investee for the fund. There's already some customer validation for the idea, and it is in a sector that you know extremely well. The proposal is to use an unusual (for us and for most VMS sectors) approach to driving viral adoption of a product which appears to have some modest network effects, and strong potential for word of mouth referrals. It sounds like we have a jump start on the competition and might be able to create a leading and protectible position.

One more problem: there is no leader for this business. I have people in the portfolio in mind with the right background and skills, but they have compelling paths in the portfolio as it stands.

PM's questions (in black) and VMS Ventures answers (in blue).

That brings us to VMS Ventures – is this something you would consider funding?

No. As you've said above, "there is no leader for this business".

If you've read our other material, you know that the entrepreneur is absolutely key for us. A passionately engaged leader, with vertical skills/knowledge (and whom CSI already knows well, so that there is low leadership risk) who is going to pour their heart and soul into the business is our number one criterion.

Let's say we find an awesome leader and each put \$500K into the venture (just for argument sake), what happens next? What are the economics of the deal – what ownership do we get for our \$500K? I assume it's based on a valuation that you would set as the lead investor?

Yes.

Given what I understand to be the structure, are you as the lead investor the ONLY investor getting the 'super-voting' shares that determine your ability to control the investee? Or do I get those in my portfolio as well?

Most of the time "control" of the investee will be split three ways between the fund, the entrepreneurial team and the CSI sponsor (i.e. your Portfolio, in this case). If the sponsor is not providing much sponsorship (i.e. has little interest in the venture other than providing a good reference for the internal entrepreneur), then the fund will be the controlling entity.

Do I get any incremental ownership for the IP/existing product I am contributing?

Yes. Plus we can probably stream the future tax losses from the investee to you as well during the early years. This could be a substantial benefit to you if the fund invests heavily in the investee which you are sponsoring.

How much equity is left with the founding employee(s)? And how do we set their compensation in this context? As true entrepreneurs they would probably be willing to

go on 'ramen pay' for a year, but they don't have the upside economics of that scenario here (as I understand it).

I believe the investee's team can generate double digit millions of value for themselves over a decade in the event that the venture is successful. After the investee's initial round of financing they will have more than half of the equity upside. Even with investees that require several multi-million dollar rounds of financing, the employees will still retain at least 20% of the equity upside.

I'm not a big fan of "ramen pay". That sort of subsistence compensation works for 20-something-year-olds living in communal housing with no dependents, but most of our employees have financial obligations. We aren't looking for them to take salary cuts to do a startup. Our internal entrepreneurs will not get the current CSI bonus compensation, but they will have an equity upside in their new venture instead. If their venture works, they will be far ahead from a personal wealth perspective. Even if the venture doesn't work, they will have invested two or three years of their career and are going to be far ahead from an experience and knowledge perspective.

How is this investee governed – do I get to sit on the board?

If you are sponsoring the investee and investing some of the capital, definitely. If you are only giving the employees a reference and wishing them good luck... unlikely.

What about the 'founder'/founding employee? Also on the board?

Yes.

Is it a 4 person board?

I was thinking 3.

Do we bring outside independent board members in to add more value (VCs do this and I think it would be great value here to avoid us ignoring reality if things aren't going well...or maybe ARE going well. Do we give that independent board member equity as compensation?

We can put them on the investee's board as observers. My sense (having been on many boards) is that the directors who really care are those who are in the industry or who have capital invested. I'm happy to have industry knowledgeable outsiders as observers if they

will add value. If the founders are OK with equity dilution as compensation for the observers, I imagine the fund would be also.

Also worth considering – there are other businesses in my portfolio to whom this venture is potentially relevant, so them contributing to the product and potentially investing, could make sense if there was upside to them for doing so.

Co-investment by other CSI business units is welcome, so long as the entrepreneur/founders of the investee are keen on having it. It also stretches the fund's investment dollars further so we can back more CSI internal ventures, so the fund would also be supportive.

Now let's say we are 2 years in, the investee is getting solid traction and making good progress. Let's say we're at \$250K in ARR but growing 200% y-o-y. The team comes to us and says.... (a variety of scenarios here)

We're doing well and have a ton of opportunity ahead. If we weren't captive to CSI, we could allow our Sponsor's competitors to use our platform. That could hurt our Sponsor's business. If we can't pursue this option though, the addressable market for the investee is smaller and there are likely to be new entrants created to serve the Sponsor's competitors.

I would not want to see the entrepreneurs/founders constrained by the Sponsor (or CSI). You can see why the fund doesn't want the Sponsor to have control of the board. Every internal venture fund I've studied has run into this issue. It usually causes the fund to be killed by its parent company, even if the fund has good returns. I'm working on setting up an independent legal framework so CSI cannot kill the fund before the \$200MM mandate has been executed.

We're doing well and have received a bunch of interest from outside VCs whom we think could help – they are willing to invest \$5M at a \$50M valuation, but won't abide by the current shareholder's agreement (providing CSI control), is there a way to deal with that?

No. We are never going to sell our shares in the investee to a third party. We are permanent partners with the founders. No outside VC will accept that. They will always want the ability to sell the company or its assets to a third party.

We're doing well but we are out of capital – outside VCs are willing to price a new round at \$50M, we'd happily take your money, can you hit the bid? Otherwise, feels like we are being penalized for being captive to CSI.

That's the price you pay for taking money from us on day zero. I think it is an extremely unlikely scenario that an outside VC would want to coinvest with the fund, so this situation is unlikely to arise.

If the business is doing well and needs cash we are going to be delighted to put up money. The entrepreneur/founders and Sponsor may not maximise valuation, but the founders are going to be rich, and they are going to be able to build a team and a company that they are passionate about.

And then if those latter scenarios (e.g. 2 & 3) happen, how do we value the company?

The fund will propose a value after studying the opportunity. If the Sponsor loves the opportunity but finds the fund's valuation unattractive, then they should turn down the fund's money and finance the venture internally within the Sponsor's portfolio. I believe Perseus is already doing this, and Cultura has a similar one on the go. Nevertheless, I think you'll nearly always find our first round valuations reasonable. We have a huge interest in launching CSI initiatives that have been nurtured within CSI.

In later rounds we will all have more information about the size and potential profitability of the market, hence our valuation perspectives will hopefully start to coincide.

And at what point does the value of those stakes crystallize for the portfolio? I assume only once the stakes are monetized/sold?

"Forever shareholders" like the fund will never see crystallization per se. The fund will get a stream of dividends or distributions of income from its successful investees. Your (the Sponsoring portfolio's) investment in the investee will provide the same stream of income (per share). You also have the option of asking (but not compelling) the fund to buy your shares in the investee. Ditto for the founders.

At any time, you (the Sponsor's portfolio) can clearly offer to buy the entire business, and if the founders want to sell to you, then the fund will sell as well.

The only instance where the foregoing would not be the case, is if the investee is very successful and goes public. The fund will continue to own the investee's shares, but the founder/entrepreneurs and Sponsor's portfolio would be able to sell.

Does the portfolio get credit for any of this organic growth annually? Bear the burden of the losses annually? Or is it completely off our P&L and on balance sheet only as a minority investment never to be consolidated and that only gets repriced on a financing event?

That's up to your boss (for bonus calculation purposes) and to the accountants (for accounting purposes).

For "cash" purposes, we'll nearly always try to flow the tax shield associated with the startup losses to the business unit or Portfolio that sponsors the investment so they can lower their cash taxes. This is a freebee for investing your time in the investee.

And then what happens if folks at the portfolio leave at some point? We've invested capital that could have paid us a bonus in an asset that has potentially tremendous value, but none of that value has accrued to us (I am making assumptions on the answers to questions above) and it's as if we have vesting options that we could theoretically have exercised if this had been a startup, but can we do that here?

Either don't leave, or negotiate some sort of valuation deal with your boss if you plan to leave. If an entrepreneur/founder of the investee leaves, they still own their shares in the investee, and will still receive dividends on them, and they will still own them if the investee goes public. They will also be able to sell them if the PM or the fund buys the investee.

PM's response to VMS Ventures answers.

Just a quick note to say thanks. As you say, this isn't a fit without a leader, and given the intent for it to be organic/internal, there is really only one option on my team I can think of and it's not a 'no-brainer' for them.

Also, we'd have some work to do just to get this ready to pitch to you, but the framework provided is incredibly helpful and will be in the back of my head as I look more broadly at our existing business opportunities, and probably at acquisitions as well.

The team is both the real constraint, and the opportunity as I see it... as I build out my team over the next 2-3 years, I'll keep this in mind as a long term career option for interesting folks.