Syndication—value in numbers

Killu Tougu Sanborn explains why venture capitalists prefer to invest as part of a syndicate, and what benefits this offers startups.

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Starting a company is an inherently risky business, but starting a biotechnology company is particularly risky because of the speculative nature of the technology and the long and costly process of bringing it to market.

High-risk, capital-intensive businesses are limited in their funding options: most conventional funding sources such as banks and angel investors will not take on such a gamble. This is where the venture capitalist (VC) enters, looking exclusively for high-growth and high-return business opportunities. VCs are willing to accept the risks that go hand in hand with the great rewards of innovative technologies. Moreover, venture funds usually have deep pockets, are under pressure to make investments reasonably fast, and, as a result, are comfortable with writing multimillion-dollar checks to startups.

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Typically, VCs do not like to invest alone, and commonly several venture funds interested in investing in a particular startup will form a VC syndicate. The term "syndication" may sound sinister—conjuring up images of a tough Mafia underworld—but in VC vernacular the term is rather more benign, referring to the formation of an investor group whose goal is to guide the company as it grows, eventually providing it with a high return on investment. Because most biotechnology VC funding is done through syndication, this article offers some insights into the rationale behind, and operation of, syndicates.

Understanding syndication

Although there are several reasons why VCs prefer to invest in "packs," the two main reasons are sharing risk and creating the best investor team.

If a VC fund invests $1 million in a $5 million round of financing, then it loses just $1 million if the deal fails rather than the full $5 million if it had funded the entire round. Sharing also limits the potential rewards, because the VC only receives one-fifth of the growth of the investment should the company succeed. Because many more companies fail than those that succeed, however, the odds are against investors, and it makes sense for a VC to limit the downside even at the expense of losing some upside.

Bringing the best investor team to the table also serves the interests of each VC fund. The more heads and hands around the table, the better the investment, although this means some loss of control for each VC fund. If a single VC company provides the entire $5 million round of funding, then a single VC would take a seat at the board of the startup, and the quality of venture investors' participation would be limited to the quality of that individual. The ideal VC would bring a long list of attributes to the company (see "Attributes of the ideal venture capitalist"), but it is rare for any one person to possess all of these qualities (and still be willing to work for a living!); most good VCs have some, but not all, of the desirable attributes.

Leaders and followers

Another important aspect of VC syndication is the notion of lead and follow-on investors. In a financing round with several VCs, it is common that one or more must step up as the lead investor. Leading the round means that the VC can set the price of the round by offering to buy the company shares at a certain valuation. If the company accepts the terms set by the lead investor, it can attract follow-on investors using the same terms, without having to renegotiate the terms with each separately. Often lead investors are willing to share with follow-on investors the due diligence materials (including research prepared on the company's technology, validity of its intellectual property, predicted market

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size, and business strategy) assembled when investigating the startup as a suitable investment. Although individual investors will do their own due diligence investigations, follow-on investors may spend fewer resources on their investigations and may choose to trust at least some of the lead investors' materials.

In general, it is the job of the CEO to attract venture funds to the company, although most high-quality, "value-added" lead VCs will help in this role. In rare cases, such as that of a very "hot" startup, there may be several lead investor candidates. This poses an interesting problem for the CEO, as the choice of lead investor will determine the nature of the VC syndicate, its operating style, and the resulting board dynamics.

Some venture funds are interested in investing only if they can lead, whereas others are interested only in following. Some funds like to lead startup investments in their own geographical regions, but might only be follow-on investors in deals farther away, as is often the case with global and national investors. Still other funds will have different reasons for preferring not to lead investments, such as their strategic focus, in the case of pharmaceutical or other corporate venture funds, or their small size, which might prohibit them from putting in the time needed to carry out the necessary due diligence.

Benefits for the startup

The formation of a VC syndicate also offers several advantages for the startup. First, a syndicate comprises a broader and more knowledgeable group of investors, including board members, who can help guide the startup through the tricky early stages of startup and growth. Second, VC syndicates provide greater financial security than does a single investor, whose departure would be highly detrimental to the company.

The combined experience of the VCs involved in the syndicate serves the interests of the startup company by providing more knowledge, judgment, contacts, cash, and breadth of business experience. Often, experienced venture investors have been involved in setting up successful companies themselves, sometimes in operating roles (such as CEO, chief financial or operating officer, general manager, head of sales, or head of marketing), and are able to contribute priceless wisdom gained through years of experience.

With the exception of a brief negotiation period, when startup and investor negotiate the best terms for each, the interests of the startup company and its venture investors are closely aligned: the success of the company is expected to translate into good financial returns for the investor once the company has gone through an initial public offering (IPO) or an acquisition. Therefore, building a strong VC syndicate that offers a broader base of experience than could be found in a single VC fund, and that can more surely guide the company to success, is in the best interests of not only the bioentrepreneur but also the VCs, and its importance should not be underestimated.

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Having a strong VC syndicate is of utmost importance for startups for another critical reason: financial backup. If the company should, for whatever reason, fall out of favor with one VC, there would still be others around to bail the company out; if the startup had just one investor, options for bridge or follow-on financing would become severely limited.

Round the table

Additional help provided by a VC syndicate materializes through the startup's board of directors. In exchange for cash, the startup gives the venture fund not only a percentage of its equity but also some control of the company in the form of a seat on its board of directors.

In a typical deal with several VC investors, the most active investor generally receives a board seat, whereas less active investors are often given the nonvoting rights of a board observer. (A board observer may attend board meetings, but does not have a right to vote, and generally does not attend executive sessions.) Some investors might be satisfied with no board representation at all. VCs with no role on the board have less control, but they are also less likely to support the company as it grows and encounters challenges along the way. On the other hand, VCs serving on the company's board of directors also face potential legal liabilities that derive from their fiduciary duties (their legal responsibility to manage the company and its assets in the best interests of the company's shareholders). In general, the process of choosing who will take a board seat follows from negotiation with each VC, and the company's directors are under the onus of making the best choice for the company.

Sometimes, venture funds that did not invest the largest sum will still get board seats. This is often the case when a VC from such a fund has something particularly valuable to bring to the board table, such as industry experience, strong business and/or operating background, good knowledge of the local industry, or simply the willingness to play an active role in the company. The latter is often the case with early-stage regional (local) funds that are able to serve as the board's and company's eyes, ears, and feet on the ground, in contrast to other investors who might be from geographically less desirable locations, or have less time to spare.

Why not give board seats to all VC investors? Experience has shown that the most effective boards tend to have no more than five to seven members, and so a company will need to choose and negotiate the board roles and decide how they will be distributed among investors.

A typical startup might hold board meetings every three months, but in a fast-growing company, the board may meet monthly, alternating between face-to-face meetings and

Attributes of the ideal venture capitalist

Integrity: The venture capitalist (VC) must be honest, fair, trustworthy, and respected by peers, have a good reputation among his or her portfolio of investment companies, be patient but focused, and be willing to work towards win–win solutions.
Deep pockets: The VC must be able to bail out the startup should the market dry up.
Industry expertise: Ideally, the VC should have knowledge of the startup's industry, good judgment, contacts, and be savvy about the technology in the startup's area of expertise.
Business experience: A VC must bring operating and investment experience from building and managing successful high-growth companies.
Personable: Good chemistry with the CEO, senior management, and other board members is essential.
Hands-on: A VC should be willing and able to actively help the company through its early stages.
Able to syndicate deals: A VC ideally should have a history of investing with strong VC syndicate partners.

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conference calls. The frequent and critical interaction between a startup and its investors makes it imperative that the VC syndicate form a board that works effectively together. This is one reason why many venture funds will often invest with "preferred partners": VCs like to know who they are working with, how those partners react to pressure, and whether operating styles are compatible under many different conditions.

To syndicate or not

Not all venture funds syndicate all their investments. Each venture investor must decide whether to form a VC syndicate or to invest alone, because the implications of that choice can significantly affect the success of the venture fund, how it operates, and its reputation among its peers.

Similarly, whether to accept an investment from a single VC, or to hold out until a strong VC syndicate is in place, is a critical decision for a startup. On the one hand, startups are constantly strapped for cash and are in danger of running out of money should new investments not materialize in a timely fashion. The CEO of a startup is therefore under pressure to accept money when and where he or she can find it, regardless of the quality of the source. On the other hand, a connection with a venture fund that is perceived as inadequate or worse can be a liability when the CEO tries to attract other venture funds, which would rather co-invest with more reputable funds.

The situation could worsen should the CEO not only choose a single investor of questionable quality, but also receive an artificially high valuation for the company. For example, if the private equity market sets a pre-money (pre-investment) valuation for the company of $5 million, and the investor offers to buy shares at $10 million, the decision to accept this sum could return to haunt the startup: the next financing round could be a flat or, worse, a "down round," at or below previous round's valuation.

In the short term, a high valuation may seem good for the startup, because it means that the investor bought fewer shares and paid more for them than if the (lower) market valuation had been honored. However, in the long term, this decision may cost the startup dearly. Both the company's reputation and its ability to raise future funds could suffer a severe blow, because other VCs might question the value of the company and the CEO's business judgment if they learn that the previous valuation round was too high, and that the company was only able to attract a single, low-quality investor.

Taking into account the factors outlined above, the key question that a fundraising CEO must answer is: "If I hold out longer to allow more time for more VCs to complete their review of my company, will my chances of attracting a high-quality VC syndicate outweigh the cost of burning cash and spending time on fundraising rather than on operating the company?" Although syndication is preferred, should the company be close to running out of funds, a CEO would be advised to lower the company's valuation to try to attract investors.

It is important to recognize that a VC syndicate is an evolving entity—as new financing rounds bring in new VC funds, so the syndicate grows and changes, and the board evolves. Which investor to accept and which to reject becomes a board decision once the company no longer holds the majority of shares.

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