

PRIVATE EQUITY MARKET IN THE ECOSYSTEM OF START-UPS AND SME SECTOR – PART 2

RYNEK PRIVATE EQUITY W EKOSYSTEMIE STARTUPÓW I SEKTORA MŚP – CZĘŚĆ 2

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Abstract: The second part of the article, whose aim is to present the PE market and its significance in young business development, presents PE / VC Funds as an alternative and more risky capital investment and describes a relation between VC funds and startups that use their support. It draws attention to the selection of the fund appropriate for the company's business profile and the importance of market knowledge. The article shows the most commonly used contractual clauses and it recommends young businesses to use lawyers support while negotiating with investors. It also presents the advantages and disadvantages of introducing the PE investor to the company, which on the one hand is a restriction on the freedom of action for business owners and originators but on the other hand, in the absence of creditworthiness, this is often the only chance to raise capital, develop and survive. In Addition, the managerial support and networking offered by the Funds allow for dynamic growth of the company's value.

Keywords: private equity funds/ venture capital funds, legal form, SME, startup, innovativeness

Streszczenie: Druga część artykułu, którego celem jest przedstawienie Rynku PE i jego znaczenia w rozwoju młodych przedsiębiorstw ukazuje Fundusze PE/VC jako alternatywną, a zarazem bardziej ryzykowną lokatę kapitału oraz opisują relację między Funduszami VC a korzystającymi z ich wsparcia Startupami. Zwraca uwagę na odpowiedni dla profilu działalności przedsiębiorstwa dobór funduszu oraz znaczenie znajomości rynku. Artykuł przedstawia najczęściej stosowane klauzule umowne oraz zaleca młodym przedsiębiorstwom skorzystanie ze wsparcia prawników w negocjacjach z inwestorem. Prezentuje również wady i zalety wprowadzenia do spółki inwestora PE, co z jednej strony jest to ograniczeniem swobody działania dla właścicieli i pomysłodawców biznesu, z drugiej przy braku zdolności kredytowej często jedyną szansą na pozyskanie kapitału, rozwój i przetrwanie. Dodatkowo, oferowane przez Fundusze wsparcie menadżerskie i networking, umożliwiają dynamiczny wzrost wartości spółki.

Słowa kluczowe: fundusze private equity/ venture capital, forma prawna, MŚP, startup, innowacyjność

Introduction

The PE market is an alternative form of capital investment for wealthy investors. Higher rates of return than in classic equity funds are facilitated by the transfer of know-how combined with cash infusion. Smart Money strongly supports the development strategy of a co-financed entity. There are less companies in the VC funds' portfolios, but they are more selective than in the case of traditional funds. The PE market plays an important role in the economy – it helps develop the economic situation in the entire region and it creates conditions for the release of „unicorns” – companies operating in the global technology industry that are

worth not less than a billion dollars. Investments in the PE/VC funds require the investors to be patient, because they freeze their financial assets often for longer than 5 years. The profit can be 2-3 times bigger than in the case of traditional investment funds, but the investors have to take into account a high risk of capital loss.

The Coverage Golden Book of Venture Capital in Poland 2018, a guide to the Polish VC market for entrepreneurs, fund partners and institutional investors is based on the survey carried out in the period from July 2017 to January 2018 which was attended by 102 founders of startups. The questionnaire of an online survey consisted of several dozen questions and has been developed

on the basis of individual interviews carried out with five owners of start-ups. This action was aimed at pointing out the most important issues in the relationship between the investor and the start-up. Entities subject to the survey had assessed a total of 29 funds. 8 of those funds belonged to the Polish Private Equity and Venture Capital Association (PSIK). The report is published by the Startup Poland Foundation, and the partner is the National Centre for Research and Development (Golden Book of Venture Capital, 2018).

Cooperation between the Fund and Start-up

While analysing the study, it is worth noting that start-ups which find investors in Poland are mainly entities operating in the following areas: Big data, Internet of Things and technologies for marketing, and over half of portfolio companies (56%) operate in the B2B business model. The study shows that entrepreneurs looking for capital in the selection of investors are mainly driven by an opinion of the environment (49%), fund's promises (45%), their experience (38%) and positive opinions (37%). The value of investment among examined surveyed entities was in 85% of cases in the range of PLN 101 thousand– PLN 3 million. Recapitalisation over 5 million was noted in one of the surveyed start-ups. Almost half of respondents declared that they use the support of one fund (47%) and 53% of interviewees have benefited from support of two or more funds at the time of the survey.

In the initial stage of the relationship between the start-up and the VC fund there are three steps that can be distinguished: Pitch deck (a short and brief presentation showing the scale of the problem and an approach to resolve it, being a business plan overview that is shown by the entity seeking capital at the meeting with the investor (www 1), the first meeting, negotiations of basic transaction conditions (term sheet), which is usually initiated by the investor, a rough analysis of the state of the company – due diligence and signing an investment contract determining cooperation rules.

Opportunities or cooperation

A high-risk undertaking looking for an investor in the VC market have an opportunity to gain an investor if their expectations and the assumed operating model are consistent with an investment strategy of the fund. Therefore, when asking for help for a given fund, the company should check if they are a part of the investment strategy of the fund, which usually covers: sectors, technologies applied by the enterprises, determined stages of the company's development, the range of investment size, time

and geographical horizon of the investment in which it is planning to allocate the capital. Funds, usually in the case of start-ups, pays attention to the business idea, its potential of development and risk. The analysis and competitiveness of the market are of great importance and the assessment of the team's ability in Start-up is also not without significance (Golden Book of Venture Capital, 2018). A careful analysis of the fund's investment strategy provides greater opportunity for better preparation of pitch deck and of obtaining financing. A good presentation is often the key to success in obtaining the capital. It should be brief, reliable and interesting enough to catch investor's interest and persuade him to have another meeting. The presentation doesn't have to be perfect, but substantive. Investors pay attention to transparency of the presentation. A key issue is a simple, understandable presentation of the problem and an idea to solve it, strategy of operations or expectations (www 2).

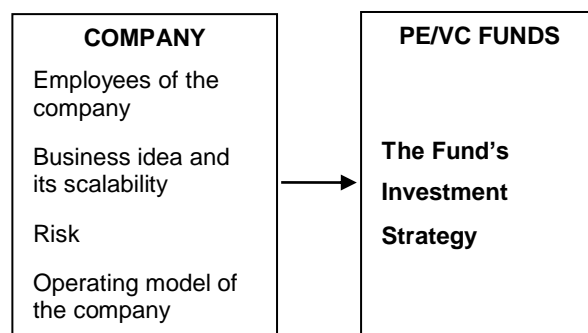


Figure 1. Investment strategy of the PE/VC Funds and the main areas of interest of the PE market
Source: own elaboration on the basis of: Golden Book of Venture Capital, 2018, p. 16-17.

A good solution is also the initial presentation of the market, giving the investor an outline regarding the situation in a given sector, which in the case of subsequent meetings and negotiations can serve as a starting point for further analysis of potential portfolio company. It will also strengthen the image of the start-up as being conscious of its own competitive position (www 1).

Due diligence investigation

Due diligence investigation is an in-depth study of the company. The investor usually carries out an analysis of the company's economic, financial and legal status with the use of external entities, in order to identify strengths and weaknesses of the company and possible threats that may influence the success of a given venture in the future. The analysis is the starting point for the valuation of the

company and negotiating the terms of investment agreement. It contains a complex and in-depth analysis of the market and competitive position of the company, as well as the formal and legal status of the examined entity, and thus helps the potential investors to make a real assessment of its potential. Cooperation of the company and the fund and well-prepared documentation are very important at this stage (Sobocińska, Sieradzan, 2004).

Due diligence investigation is mainly conducted in the case of high amounts of financing. From all the respondents 72% of startups (73 companies) have completed this stage. Among them, only in 16.7% of the cases (12 companies) the costs of the studies were covered from the Funds. 68% of companies subjected to due diligence investigation have been splitting the costs of the analysis with the Fund (Golden Book of Venture Capital, 2018).

After accepting the company's business plan and a positive due diligence assessment, the fund may decide to transfer the smart money to the examined entity. After that it is time to negotiate the conditions of the investment agreement.

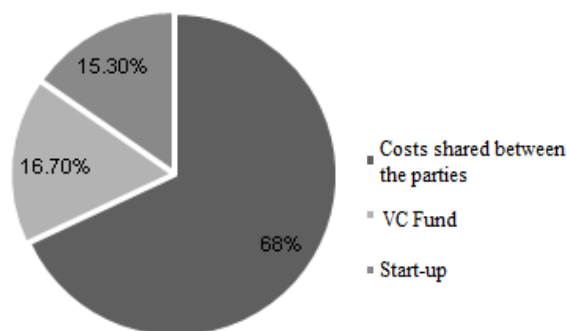


Figure 2. Due diligence costs
Source: Golden Book of Venture Capital, p. 34.

Term sheet and investment agreement

Conditions of the investment agreement were received by most respondents within 3 months (less than a month 23%, 1-3 months – 43%) and less than 70% had signed the investment agreement within a period not exceeding half a year (it took less than 3 months for 33% of the examined enterprises, 36% were in possession of the contract over the period from 3 to 6 months).

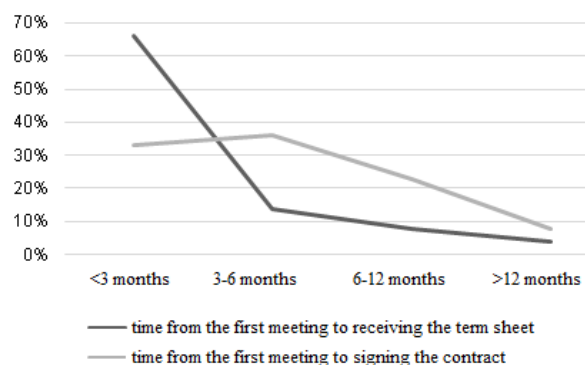


Figure 3. The time after which the examined companies have received investment terms and signed the investment agreement

Source: own elaboration on the basis of: Golden Book of Venture Capital, 2018, p. 25, 34.

Despite often limited experience of the respondents, the majority of them assessed the documents that they had signed as understandable (Term sheet: fully understandable – 62%, partially unclear – 38%, investment agreement: fully understandable – 54%, partially unclear – 46%) (Startup Poland, 2018). A considerable number pointed to a limited possibility to modify contractual clauses. That was a problem mainly for people who took steps in business for the first time (74% - 15% of them admitted that the agreement was not negotiated) whereas 44% of serial entrepreneurs fully matched contractual clauses to their needs. Therefore, it is recommended that start-ups should use the support of lawyers experienced in the preparation of investment agreements while negotiating with investors. Increasing awareness among start-ups may not only strengthen their position in contacts with the VC funds, but also contribute to the professionalization of the private equity market (Golden Book of Venture Capital, 2018). While analysing the above figure, it can be noticed that as the level of financing round increases, investors abandon one-off payments of capital (change of trend for amounts above PLN 3 million results from a small number of transactions of this value among respondents – 10%). Such action is not a coincidence – on one hand, investors tranching investments aim at limiting the already high risk and on the other hand, they encourage the co-financed start-up to realise its intended business objectives.

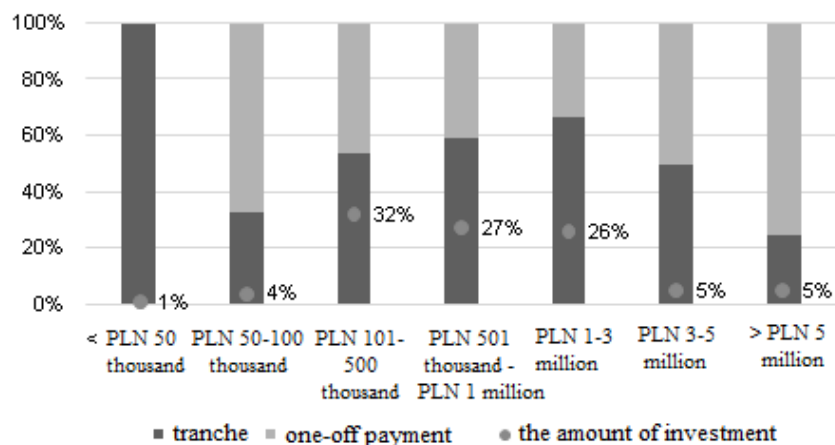


Figure 4. The value of investment round and tranching

Source: own elaboration on the basis of: Golden Book of Venture Capital, 2018, p. 39.

The PE investments carry high risk. Despite a high potential for development, young and inexperienced entities may not survive in an increasingly demanding market with a high competitiveness in almost every sector. Thus the funds allocating their capital in a given undertaking should therefore expect losses. However, the risk is not only on the investor's side. Companies looking for support on the PE market present a set of information during meetings with the funds. However, negotiations do not guarantee signing the investment agreement, and revealing information may result in using a business idea by another entrepreneur. Table 1 presents a list of the most frequent protection in the process of negotiation and duration of the investment agreement, which protect both the investors and supported the smart money company.

Apart from the above-mentioned clauses, taken into account for signing the investment agreement, the Funds want to limit the risk and therefore they use tranching. They do not pay the company the whole amount of money, and disbursements of the capital depend on achieving specified milestones by the portfolio company. Investors lose less money in the case of failure and young entrepreneurs do not lose motivation to reach the target. A proper implementation of the business plan enables the founders of the company to obtain subsequent financing rounds, and thus a development of the undertaken economic activity. It increases the chances of a given undertaking for success, which in turn influences the profits obtained by the assisted business initiator and maximizes the investor's return rate.

Table 1. Collateral and clauses during the duration of the investment agreement and negotiations on the side of the investor and the company's founder

| Company | Investor |
|--|--|
| <p><i>Non-disclosure agreement</i></p> <p>The contract signed before starting the process of negotiations, securing the company's founder against revealing economic information by the investor, especially know-how, and using information to other aims than those being the subject of negotiations.</p> | |
| <p><i>Term sheet</i></p> <p>A document signed before concluding an investment agreement, containing basic transaction conditions between the investor and the company's founder.</p> | <p><i>Term sheet</i></p> <p>A document signed before concluding an investment agreement, containing basic transaction conditions between the investor and the company's founder.</p> |
| | <p><i>Priority right</i></p> <p>It protects the main investor against losing control over the company in the case of planned partial or entire disposal of shares in the company by the transferor partner. The investor or a person indicated by him will have a priority right to purchase the shares according to specified conditions.</p> |

| Company | Investor |
|--|---|
| | <p><i>Drag Along right</i></p> <p>Under this clause, the investor willing to dispose of possessed shares is entitled to demand from other partners of the company agreement to sell their shares to the proposed buyer. The investor protects the right to exit the investment in this way.</p> |
| | <p><i>Tag Along right (Right to join)</i></p> <p>In the case of the transfer of shares from the partner, the investor can join in a transaction via sell all of his shares to the proposed buyer.</p> |
| <p><i>Lock-up</i></p> <p>Ensuring a non-disposal period of the shares for a specified time from the moment of signing the investment agreement.</p> | <p><i>Lock-up</i></p> <p>Ensuring a non-disposal period of the shares for a specified time from the moment of signing the investment agreement.</p> |
| <p><i>Contractual penalty clause</i></p> <p>Obligation to pay a specified sum of money in the case of improper performance or non-performance of a non-cash obligation by one of the contacting parties.</p> | <p><i>Contractual penalty clause</i></p> <p>Obligation to pay a specified sum of money in the case of improper performance or non-performance of a non-cash obligation by one of the contacting parties</p> |
| | <p><i>Operational exclusivity clause</i></p> <p>A ban imposed on the company's founders in terms of conducting activities different than for the company being the subject of the contract, which increases the chances of achieving the objectives set by the investor.</p> |
| | <p><i>Non-compete clause</i></p> <p>Obligation imposed on the company's founder not to run a competitive business, both personally and through related entities without the consent of the investor and supervisory board of a given company.</p> |
| | <p><i>Underperformance</i></p> <p>Supervention of unsatisfactory results. A clause entitling the investor to take control over the company in the case of failure to implement the turnaround plan within 3 months as a result of the company's failure to realise objectives of the business plan for a period longer than 3 months. This provision aims at protecting the investor if the founders fail to achieve certain milestones and Key Performance Indicators (KPI).</p> |
| <p><i>Incentive programme</i></p> <p>Defining operational aims, time of their realisation and benefits appertaining to founders of the company after meeting the milestones specified in the programme within the time frame required.</p> | |
| | <p><i>Anti-dilution provision</i></p> <p>The agreement between the parties of the company in terms of dilution of shares – protection of the main investor against a reduction of percentage share in the share capital of the company.</p> |
| <p><i>Earn-out</i></p> <p>Determining the price for the shares subject to additional premium for the seller in the case of growth in value of a given company.</p> | <p><i>Earn-out</i></p> <p>Determining the price for the shares subject to additional premium for the seller in the case of growth in value of a given company.</p> |
| | <p><i>Liquidation preference</i></p> <p>Provision specifying the order and degree of distribution of the company's capital in the case of its liquidation. In this case, a preferential position belongs to the investor, who in the event of liquidation or sale of the company is guaranteed the ability to recover a part of the capital invested in a given undertaking.</p> |

Advantages and disadvantages of private equity financing

The introduction of the Private Equity investor may cause concern for the company's owners. Exemplary consequences include a limited liberty of action, organisational culture based on business relations or a formalised decision-making process. However, in the case of enterprises in the stage of sowing, young entities or start-ups, these concerns are in eclipse as their ideas often would not have a chance to be realized without the support of VC funds. Table 2 presents the advantages and disadvantages of financing ventures with a high risk capital financing.

Introducing the PE/VC investor to the company requires the owners to think what is more important for them – full independence, or a chance for dynamic development and obtaining a leader position on the market, which is especially important in the case of young and inexperienced entities.

Funds can help to develop entity to strengthen its market position and gain the image of an innovative company. It is possible, thanks to a wide network of contacts, for cooperation with the high-tech sector and experience what funds possess. The necessity to announce financial results to the investor that was listed as a disadvantage may become salutary – early detection of any problems will enable a rapid response, and thanks to the support of the Fund that also cares about achieving the assumed success and development. Lack of sufficient creditworthiness among start-ups or small and medium-sized enterprises creates an equity gap, which is filled by the Funds. Indeed companies lose full control over the enterprises, but they are given the opportunity to mark their presence on the market and implement innovative solutions, contributing to the increase in efficiency of the economy and reducing unemployment through generating new jobs (Sobańska i Sobański, 2004).

Table 2. The advantages and disadvantages of introducing the Private Equity investor to the company

| Advantages | Disadvantages |
|--|---|
| Long-term nature of investment | Change in the way the company functions |
| Critical evaluation of the business plan and the company's performance | Loss of control of the company |
| No costs for the current debt servicing | Access for investors to confidential information |
| Acceptance of high risk, no need for creditworthiness | Provisions in the investment agreement protecting mainly the investor |
| Managerial support | A necessity to announce financial results and implementation of strategic assumptions to the investor |
| Brain capital | |
| Standardisation of the company management system | |
| Networking | |
| Greater resistance to market changes | |
| Improvement of the company's image in the sector | |
| Strengthening the market position | |
| Increase in the motivation of employees | |
| Dynamic growth in the company's value | |

Source: own elaboration on the basis of: Sobańska i Sobański, 2004, p. 16-27.

Conclusions

The Private Equity market is treated as a catalyst of technological change. Thanks to expanded business relations, capital and know-how, the funds enable, especially young enterprises to achieve market success. They contribute to the innovativeness of the economy by supporting innovative solutions (Sobańska and Sobański, 2004). Moreover, start-ups or small and medium-sized enterprises which are supported by the high

risk capital are characterised by a higher flexibility in the context of the evolving technological environment and fostering the development of research and development activities (Grzywacz i Okońska, 2005). Taking into account the positive correlation between the openness for innovation and VC investment in the professionalisation of the PE market, as well as the fact that Poland is the most attractive region in Central and Eastern Europe for PE transactions, it can be concluded that Poland has an opportunity to get out from the end

of the European innovation tide. It is fostered by the research on start-ups' relations with VC funds, which facilitate identification of areas that should be worked on in order to achieve better results of cooperation.

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