A guide to venture capital

As more Singaporean startups emerge, they attract investors hungry for returns in the current low interest rate environment. Venture capital funds are important in the startup ecosystem as they invest in risky ideas.

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ACCORDING to the Singapore Venture Capital and Private Equity Association (SVCA), venture capital for technology-related startups in Singapore has risen sharply from US$27.9 million in 2011, to US$1.71 billion in 2013.

This represents a staggering sixty-fold increase.

Within South-east Asia, Singapore has also taken the lion's share of the region's venture investments, estimated at around US$2.7 billion in 2013.

Notable examples include GrabTaxi, South-east Asia's leading transportation application, which recently announced that it had raised more than US$350 million, bringing its total funding to US$700 million.

The venture capital scene in Singapore has grown in tandem with the rise in technopreneurship.

PriceWaterhouseCoopers (PwC) reported that technology-enabled startups are expected to contribute 2 per cent to Singapore's gross domestic product (GDP) and provide 168,000 jobs by 2035, compared to its current GDP contribution of 0.1 per cent and approximately 5,000 employees.

As more Singaporean startups emerge, they attract investors who are hungry for returns in the current low interest rate environment.

Other attractive factors include a sound rule of law, a relatively low corporate tax rate, and the availability of startup incubators/accelerators to help investors identify promising startups.

These investors provide venture financing, facilitating further growth in the companies and perpetuating a positive feedback cycle.

The process of venture financing

Typically, most startups in their early stages are unprofitable.

Funds are spent on growth strategies such as extensive marketing, user acquisition and talent recruitment, so as to compete for a greater market share and to attract the brightest employees.

Without a reliable stream of cash flow or assets to pledge as collateral, many of them are unable to access borrowings from banks.

Equity financing is usually the only option available to such startups.

However, unlike public companies listed on the Singapore Exchange (SGX), small private startups are unable to garner capital from retail investors.

This leaves them with no choice but to approach parties such as high net worth indivuduals (commonly known as "angel investors"), family members and friends, or venture capital firms.

It will be beneficial for entrepreneurs to think about the suitability of a potential investor, as opposed to settling for anyone who comes by.

An investor who is familiar with the business vertical that the startup is operating in will be able to add value. This can be done via providing advice or helping the founders establish connections with other potential business partners.

Conversely, an inexperienced investor may not be able to add value, or worse, impede the progress of the business. Once a potential investor has been identified and connected to, either via unsolicited emails or investment pitches during startup networking events, preliminary due diligence begins.

A non-disclosure agreement will usually be signed between the startup founder and the investor.

The former will seek to convince the latter to invest in the business by explaining the business model, management team and financial prospects of the company.

In the meantime, the investor will do market research on the startup by looking up on companies operating in the same industrial segment.

A suitable valuation and investment quantum for the startup will also be determined.

If the investor is satisfied with the company and intends to make an investment, he or she will sign a term sheet with the startup.

A term sheet is a document which expresses the intention of the investor to finance the company.

It also includes legal terms and conditions pertaining to the potential investment. After the signing of the term sheet, further due diligence may commence.

The startup may have to provide the investor with more documents and participate in more meetings with the latter, so that the description of the business and its prospects up to this point can be corroborated.

The process will culminate with the signing of shareholder subscriptions and agreements, which would make the investments legally binding.

Lastly, funds and shares will be transferred between the parties.

Specialised equity financing

Unlike traditional equity financing, venture capitalists and angel investors usually do not purchase ordinary shares in the startup.

Instead, they often purchase specialised equity instruments. The most common one is a convertible preferred share (CPS), a special class of equity which allows the holder to enjoy certain rights and privileges.

The ability to convert CPS to ordinary shares, on a 1:1 ratio, allows the holder to sell the shares in the event of a sale of business or an initial public offering (IPO).

The nature of the CPS enables the investor to minimise the downside, while allowing them to participate in as much of the upside as possible.

They normally include, but are not limited to:

1 Liquidation preferences

Liquidation preferences allows the investor to preserve as much of his original investment as possible in the event of a business liquidation event such as a bankruptcy, which is not uncommon among early-stage companies.

During a liquidation event, the investor holding the CPS will be able to recover his original investment first before the other shareholders.

The remaining liquidated assets will then be pro-rated and distributed to all the shareholders, including the CPS holder.

The distribution will depend on the size of the equity stake held by each shareholder.

Therefore, not only will this clause minimise the erosion of the original investment, the CPS holder will also be able to increase his returns during a business sale.

2 Anti-dilution provisions

Entrepreneurship is normally not a bed of roses.

When the business hits a speed bump and needs to garner additional equity financing, the price per share will usually be lower compared to the previous investment round, due to the weaker business prospects.

This is known as a "down round". The value of shares held by the company's existing investors will inevitably be reduced, and anti-dilution provisions seek to mitigate the impact.

Anti-dilution provisions increase the number of ordinary shares that the CPS can be converted to, so as to compensate for the fall in value per share.

For example, the original investment held consists of 1,000 CPS shares priced at S$2 each, representing a total value of S$2,000.

With a down round, the price per share for a new financing round may be reduced to S$1 per share, resulting in a paper loss of S$1,000 on the original investment.

An anti-dilutive provision may then increase the conversion ratio between CPS and ordinary shares, such that the 1,000 CPS shares can be converted to a greater number of shares, reducing the potential loss.

The formula for calculating the conversion ratio may differ between investors.

Thus, it will serve the startup well to consult a lawyer on the potential repercussions in the event of a down round.

3 Drag-along rights

An acquirer will usually require a business to sell all of its shares in order for the acquisition to be completed.

Drag along rights protect the majority shareholder.

They allow the majority shareholder to drag along, or force, the minority shareholder into a sale of their equity stake.

Specifically, drag-along rights require all the shareholders to sell their shares to the acquirer, when the percentage of shares owned by shareholders who are willing to sell their stakes rises above a pre-determined threshold.

This prevents the scenario in which minority shareholders, including the startup founders themselves, are unable to reach a consensus on a business sale decision.

4 Tag-along rights

Occasionally, an individual shareholder may receive an offer to sell his or her equity stake.

When this happens, tag-along rights, which protect the minority investor, entitle the holder of preference shares to "tag-along" to a sale and sell part of his or her stake to the acquirer as well.

Such rights enable the investor to receive an equal opportunity to realise the investment's returns, increasing the liquidity of the shares.

Both drag-along and tag-along rights may be made available to all shareholders, and not just the startup investor.

What do investors look out for?

While an exhaustive list of qualities that investors look out for does not exist, there are certain business attributes that will entice a venture capitalist to take a second look.

Shannon Lee, an analyst at the locally based venture capital firm NSI Ventures, said:

"We all look out for a few key traits: Firstly, there should be a strong and experienced senior management team which understands the industry, the business's competitors and psyche of the potential customers.

"Secondly, the business should be selling a product or service that has a unique selling point and is suitable for the targeted market.

"Thirdly, the management should be able to show strong operational metrics as well as an ability to scale the business."

While startup founders source for capital to finance their entrepreneurial dreams, it would serve them well to seek legal help to scrutinise the terms and conditions attached to the potential investments.

Alternatively, the founder can consult other startup owners to see if they are getting a good deal.

Ultimately, if things happen to turn sour between the founder and investor, there will always be a legal agreement written in black and write to fall back on.

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