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Reward v. Risk

Advantages and Disadvantages of Courting Strategic Investors.

Venture-backed companies often have the opportunity to accept an investment from a strategic investor. These opportunities typically come in later financing rounds after the company already has one or more venture capital (i.e., financial) investors. There are distinct issues that should be considered when deciding whether to accept such an investment.

Potential Benefits

Market/industry credibility. An investment by a successful and well-respected player in a company's industry is a sign to the market that an investor who really understands the industry believes in the firm's business model and/or technology.

Build a relationship with a helpful partner and/or potential acquirer. A strategic investor often allows a company to expand or accelerate its business through the investor's distribution network, sales and marketing infrastructure or other facet of its business. In addition, a successful business relationship with a strategic investor may lead to an acquisition by the investor.

> The interests of the strategic investor may diverge from the company's interests, which could lead to the investor's diminished support for the company.

Fewer control issues. A strategic investor is less likely to micromanage its investment or insist on control over (or veto rights with respect to) significant decisions. However, because a strategic investor's principal goal often is to benefit or advance its own business, the investor may attempt to influence the development path for the company's technology or its product development plans.

Potential higher valuation. A strategic investor's interest in a company relates to how its success can benefit the strategic investor's core business. Accordingly, a strategic investor is typically less valuation sensitive and, therefore, the investment is less dilutive. Of course, higher valuations lead to higher expectations and less tolerance from the company's financial investors.

Less focus on exit or return on investment. For the same reasons, a strategic investor is less likely to pressure a company to sell early in order to maximize the return on investment. To gauge this, a company can try to determine how the individuals who manage the investor's investments are compensated and, therefore, their motivations (e.g., financial return versus strategic value to the investor).

Potential Risks

Spook potential customers or other business partners. The competitors of a strategic investor are less likely to want to become customers, business partners or acquirers of the company. They fear that the strategic investor could gain access to information about them that might give the investor a competitive advantage. Additionally, they typically do not want to indirectly support their rival.

Interests may diverge. The interests of the strategic investor may diverge from the company's interests, which could lead to the investor's diminished support for the company. For instance, the strategic investor may determine that the market's adoption of the company's technology may hurt some portion of the investor's business.

Investment in competitors. A strategic investor often invests in multiple companies in the same industry and so may invest in a company's competitor. This leads to the risk of disclosure of the company's trade secrets and other sensitive information to that competitor. In addition, the strategic investor may become conflicted if the company's success is threatening to the other investment.

Will want something else. A strategic investor almost invariably wants some concession from the company in connection with the investment and on favorable terms. Such concessions may include an exclusive or semi-exclusive license, distribution or marketing rights, or a development agreement. And sometimes a strategic investor will require a right of first refusal on the company, which has a chilling effect on the market for other potential acquirers.

More time to close. Because strategic investors tend to be large, bureaucratic organizations, the investment process tends to include more steps and consequently takes longer.

Accepting an investment from a strategic investor can have significant positive and negative impacts on a company's future, so that decision must be made carefully.

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