The Trouble with Strategic Financings

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While early stage technology companies typically seek investment from angels and VCs, strategic investments from commercial partners can also be a valuable source of capital. Strategic investors can often offer higher pre-money valuations than angels or VCs since they may be gaining in other ways from the relationship. In addition, if the capital investment is intelligently combined with a commercial agreement, the overall result may be greater than the sum of its parts. Despite the potential advantages of such financings, however, negotiating the financing and commercial arrangements together results in a unique set of issues, and startups should be aware of these before embarking on a strategic financing:

Increased Complexity; Importance of Understanding Commercial Terms. Adding a commercial agreement to a financing transaction can add disproportionately to amount of time and expense that will be needed to get to closing. The legal documents for early-stage equity investments are often based on well-known forms; lawyers that are experienced in early stage financings can provide specific guidance on deal terms. Commercial agreements, on the other hand, often require the business principals to become more directly involved in the negotiations, since their terms are driven much more by the day-to-day realities of the company's business. The company's management should therefore realize it will likely have to put significantly more time and effort into hashing out deal terms than in a pure financing transaction. If the company's lawyers are involved in negotiating the commercial agreement in addition to the investment documents, the legal fees may also be significantly higher than in a VC or angel financing. Some of the requested terms, since not financial in nature, often go to the heart of what creates value in the business and, therefore, if not carefully considered and negotiated, can result in a reduced value of the company after the financing. For example, it is not uncommon for strategic investors to ask for an exclusive relationship of some sort (whether as an exclusive provider or re-seller of the company's products or services), and companies should carefully consider the foregone opportunities. Some strategic investors also insist on special access to intellectual property rights, or on covenants not to sue, which can chill future acquisitions.

Different Incentives. When an angel or VC makes an investment in a company, their ultimate goal is fairly clear: to get a strong financial return on the investment. When a commercial partner makes a strategic investment, they are likely to be motivated by a combination of financial returns on the company's stock and the commercial relationship. The multifaceted goals of strategic investors can ultimately bring them into conflict with the founders in ways that would not happen with VCs or angels. For example, if the company later receives an offer to be acquired by a competitor of the strategic investor at a high valuation, the founders and financial investors may want to take the deal, but a strategic investor may want to prevent it, even if it stood to receive a significant return on its investment in the acquisition. The company will need to keep these dual motives in mind in a strategic financing, especially when it comes to negotiating provisions that govern future financings or a sale of the company.

While teaming up with one of the major players in a company's space can seem like a very good idea, and may create more value than could be expected from an angel or VC investor, care needs to be taken to avoid pitfalls common to these relationships, including the possibility the relationship with the new partner deteriorates, with that partner having disproportionate leverage.

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