

## One Way Out (The Venture Investor's Put Option)

Private venture investors consciously embrace the notion of swapping liquidity and safety of principal in the pursuit of *positive asymmetrical outcomes* and the higher risk premium associated with venture capital. Against the certainty of uncertain outcomes, the venture investor accepts liquidity and principal risks as the apropos *quid pro quo* towards achieving high double-digit and triple-digit IRRs on investment.

But, venture investors too willingly accept the notion that their investments outcomes will be the result of a binary set of events—characterized either by loss of capital or an attractive multiple on exit as the result of an IPO, sale, merger or other change of control transaction.

These investors can become more effective fiduciaries of their capital by demanding investment terms that broaden the variety of each investment's potential returns. I refer to this as increasing an investment's "*optionality*" beyond a binary set of boom or bust outcomes.

Among the most frustrating venture investment experience is the non-outcome outcome. In an earlier post ([Hits & Exit Wounds](#)) we described this sort of venture purgatory as "My Grandkids Company"—a private company that is successful but there is no exit in sight. (Perhaps your grandchildren's inheritance?). You were prescient enough to back an early-stage venture that is now successful yet all you have to show for it is an annual K-1. This is where investment term sheet mechanisms that enhance the investor's optionality really come in handy.

I have become a strong proponent of requiring that venture investors demand a "put right" (or, *put option*) as a contingency to committing venture capital to an angel round or early-stage equity financing. A well-conceived put option may reduce unintended gifting to your grandchildren by giving you one way out of a private investment without an exit in near sight.

Typically, a venture investor's exercise of a "put" would require the company to repurchase their equity securities at fair market value. Investor put rights have been around venture transactions for years for the express purpose of providing a way out of an investment with no liquidity event in near site. But, because of the terms by which they have generally been structured, they have been rarely exercised.

That's because if the company appears to be on the right track, investor's are more likely to let their fortunes play out. On the other hand, if the company is not performing to plan it is not likely to be able to afford to honor the investor's put—rendering the option worthless.

With investors rarely exercising these puts and with companies generally apprehensive of the uncertain implications of any non-budgeted hit to their balance sheet, issuers are less willing to draft investor put rights into their offerings...but you should insist.

It works like this...upon completing due diligence and deeming a venture to be worthy of a capital commitment the investor reviews the company's anticipated revenue projections to identify a period in the future (beginning at 30 or 36 months out) at which the company's cash flow model and pro forma balance sheet suggests that it would be able to return the investor's initial capital contribution along with any accrued dividend. As a contingency to financing the venture, the investor requires the company to grant a put option for that future point in the company's growth trajectory.

If the investor exercises the put, the investor is entitled to redeem all or a portion of their equity interests in exchange for the initial capital contribution value plus a nominal return above the risk-free rate. In addition to the return of investment, the put right allows the investor to maintain a reduced equity position in the company...perhaps, somewhere between 50% to 75%. (This would imply an increase two to four times higher than the company's initial valuation)

Essentially, the exercise of the put allows the investor the ability to take "risk off the table" (the initial contribution) while still maintaining a material amount of "skin in the game".

To prevent the investor from exercising the put at a moment when the company's financial stability or expansion plans could be jeopardized, the company can require that in addition to a prescribed time period restriction, certain revenue and/or R&D milestones must be achieved and set as "triggers" before the put may be exercised.

The put option must be constructed in a manner that enhances the investor's optionality, without putting the company at balance sheet risk. It is possible to achieve that balance. The company that achieves the predetermined revenue milestones would likely savor the opportunity to buy back its stock to the pro-rata benefit of the remaining stakeholders, and of course the investor benefits from the possibility of a wider variety of liquidity events and exit outcomes...which, in turn, enhances the ultimate [appeal of venture capital as an asset class](#).

Source: VenturePopulist, Jeff Joseph, CEO, Prescient Advisors