VCs Reveal Appetite for Governance

By Michael K. Lorelli

From left: Matthew McCooe, Chris Barkley, and Peter Londa

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The number of public companies in the United States has been shrinking, with only about 3,600 firms listed on the two major exchanges as of the end of 2017. That's roughly half as many publicly traded companies as there were a decade ago. The decline can be explained in part by a rise in mergers and acquisitions. At the same time, private equity investment has exploded. Today, there are an estimated 17,500 portfolio companies, according to Private Equity Info.

And here's another eye-opening statistic: there are an estimated 1,047 venture capital (VC) firms in the United States with investments in more than 8,000 companies, according to the National Venture Capital Association. Most of these companies have boards even though there is no legal requirement to do so. The reasons behind why private companies are embracing boards was the subject of a panel discussion moderated by the author earlier this year at an NACD Connecticut Chapter event. Serving on the panel were Chris Barkley, managing director of Platform Ventures; Peter Londa, CEO of the smart grid technology company Tantalus Systems; and Matthew McCooe, who was named CEO of venture capital firm Connecticut Innovations (CI) in 2015.

Tantalus, which is backed by Redpoint Partners, CI, and Discovery Capital, has a board comprised of two independent directors, one director from a VC firm, and one company executive. There are two committees, compensation and audit. "Having a board, particularly with representation from independent directors, leads to better decision making and is necessary to meet the fiduciary responsibility for all shareholders," said Londa.

CI is one of the largest VC firms in Connecticut, with investments in 185 companies. It was started in 1989 when the state legislature decided to help promising technology companies get off the ground. CI remains a quasi-public arm of the state, offering between $25,000 and $5 million in financing and support for growing companies therein.

"All of the companies we invest in have boards," said McCooe. "A good board can help management think through thorny, complicated problems. Where the management team may be tackling an issue for the first time, the outside directors have probably been down that road eight or ten times before."

CI has posted positive returns from 2010 through 2018. "Our funding bridges the gap from a great idea in a garage to a product on the market," McCooe said. "And we give young people good reasons to live and work in Connecticut's small cities." McCooe's formula is a board of at least five and a maximum of seven members, and he takes a board seat, or at least a seat as a board observer.

"Either they have a board or we create one," Barkley said. "It's important for governance, helps create transparency, helps liability with [limited partnerships], and creates a reporting relationship that is a good discipline for the management team."

Over the course of the conversation, the panelists discussed the following steps a privately held company can take to form an effective board.

Seek the right skills. Barkley said he looks for category expertise, with his sweet spots being consumer products and technology-enabled businesses. Londa said his board seeks "individuals with operating experience and domain knowledge to enhance the expertise of investors who serve as directors, who may not have held senior leadership positions in an operating company." McCooe scouts for "deep experience and a great Rolodex. But every situation is different. A bio- or life sciences company would have very different needs" than, for example, an information technology company, he said.

Find outside directors. Investment bankers are one source for director candidate referrals. "I have fortunately been introduced to excellent independent directors through investment bankers in our space," said Londa. "We leverage the networks of investors in the space, and recruiting firms often flow in candidates."

Barkley added: "We let management nominate people they know, particularly in the space, and we leverage our own investor contacts and professional networks."

Going with people you already know and who others within your firm have met while performing their due diligence processes is also a valuable means of identifying talent. "If we don't already know people in the space, we probably shouldn't be investing in the company," McCooe said.

Create a director compensation plan. While nearly every VC portfolio company is starved for cash while in negative operating profitability mode, options and no cash seem to be the most common currency for directors. Tantalus initially gave its directors a grant equal to a half percent of the equity, with a four-year vesting schedule, and later added cash and additional cash fees for committee chairs. Platform Ventures starts with zero cash, and options usually at a single percentage point of equity, but adds between $30,000 and $45,000 in cash later, in addition to the vesting options, as the company passes the all-important cash-flow positive milestone. CI sees options valued between a quarter and 2 percent of equity, depending on the company's stage.

Establish meeting frequency. Londa noted that in his experience, board meetings are initially monthly and typically run about 90 minutes, and quarterly reporting meetings last upwards of two to three hours. "The financial and operational discipline associated with prepping for the meetings was very helpful, but resulted in up to three days of time for members of management to prepare materials," he said. "We migrated to six meetings per year, which was a huge relief. The prep workload cascades down the organization."

For Barkley, quarterly is the standard. McCooe similarly prefers a cadence of quarterly in-person meetings augmented with an hour-long phone call each month.

Consider directors' financial investment. CI never requires outside directors to invest, but they're welcome to co-invest. McCooe believes independent directors are already taking on reputational risk in serving a VC-backed company. Barkley agreed that investment by independent directors should be entirely voluntary and not a condition for board membership, but added, "A lot of times, the new independent directors are eager to participate so as to improve their own return. It adds alignment between the management team and the board."

Judge success. McCooe advised attendees to look at the existing investors and their track record, values, and personalities, and whether those are consistent with your own. "You want to see and feel alignment with the investors, and confidence that the CEO is a winner," he said.

Barkley believes the best view is the company's balance sheet, and a board candidate should look for enough cash to cover the burn rate for a reasonable period of time. "Then add your own perspective on the company's ability to scale, and in a big enough market," he said.

Londa noted that VC portfolio companies report financials. "Ask for the audit," he said. "Is it from a reputable accounting firm? Read the audit notes!"

Understand the risks of VC backing. "It's not for the faint of heart," Barkley said. Added Londa: "Think about the company's stage in the life cycle. Early-stage companies are focused on proving product viability. Then comes the effort to commercialize the business model, followed by the need to generate profitable and sustainable growth. Convince yourself that a potential company has a management team that can lead beyond innovating." McCooe reinforced the need to assess the time commitment. "The biggest risk," he said, "is the inherent opportunity cost of your time."

Fish where the fish are. We'd all like to be on the board of the next Apple or Uber Technologies, but that foresight eludes even the VC firms. It also pays to remember history: in 1983, Hewlett-Packard Co., Xerox PARC, and IBM didn't see a market for personal computers. In your pursuit of board engagements, if you want to fish where the fish are, keep in mind those 8,000 VC portfolio companies and 17,500 private equity portfolio companies.

Also consider the ratio of risk to reward when considering serving on a PE- or VC-backed board. PE firms generally invest in newer businesses, but with positive cash flows and better returns than public companies. While venture capital may bring the promise of Uber-like returns, investors and independent directors alike may need a bit more intestinal fortitude. Directors with the time and interest in serving on multiple boards might think about their own board diversification strategy. Perhaps one public board, one or two private equity boards, and one or more speculative VC-backed companies. Just keep in mind that as you calculate the return on your time, as the saying goes, your actual mileage may vary.

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