Pillsbury Winthrop Shaw Pittman LLP

## Corporate & Securities

**Joseph Chan**
+86.21.63351128
joseph.chan@pillsburylaw.com

*Joseph Chan is the Managing Partner of Pillsbury Winthrop Shaw Pittman's Shanghai office, co-leader of the firm's China practice and a member of the firm's Corporate & Securities practice.*

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# How Do Venture Capital Investors Add Value To Portfolio Companies?

by Joseph Chan

Emerging growth companies are always eager for capital to finance growth. Capital in the monetary sense is in the forefront of every entrepreneur's mind when it comes to seeking funding from venture capital and private equity investors. And for good reasons. Without the necessary capital, it is hard for an enterprise to build up its business. For any business to grow, it needs to hire the right talent, build the team, introduce the right products etc. Recently, a well-known venture capitalist in China commented that today's China is a heaven to entrepreneurs. There is a fair bit of truth to that statement. Whereas 15 years ago it was difficult to find a venture investor active in China, today's China is awash with seasoned venture investors. Capital is abundant. China-focused funds that are to the tune of $200 million and up seem to be an increasingly common occurrence. What entrepreneurs should bear in mind when looking for investors, however, is that beyond the supply of capital, there are other important – perhaps equally important – attributes that entrepreneurs should seek in a potential investor.

Broadly speaking, these attributes can be categorized into two types of "capital": intellectual capital and relationship capital. The supply of these types of capital is true value-add. What is value-add in the venture universe? Simply put, it is the provision of assistance and services, beyond a mere supply of capital in the monetary sense, that helps an enterprise increase in value such that at subsequent rounds of financing, such enterprise's valuation would be on an ever-rising upward projectile. A successful venture investor in the Silicon Valley once noted that when he is actively involved in his portfolio companies, he can achieve a return in the magnitude of 70%. When he is merely a passive investor, his return drops to less than 10%.

Many venture investors have direct, relevant industry experiences. Many venture investors try to build up sector or domain expertise. Their deep industry knowledge and operational experience can save a company from making common or avoidable first-comer's mistakes. Particularly for early stage companies, an experienced investor's help in devising a viable strategy is critical to the future success of the enterprise. A value-added investor also often acts as a sounding board or coach to senior management, especially the CEO. These are all attributes that I would describe as intellectual capital. Not capital in the monetary sense to be sure, but critically important ingredients that are needed to move an enterprise forward in the right direction and along the right path.

Seasoned investors also supply what I call relationship capital to their portfolio companies. Venture investors have a rich network of relationships in the relevant business and investment communities. Among the portfolio companies that they monitor, they know who the key players in a particular industry or market segment are and who may be a good candidate as customer or for partnering relationship. Such investors also know other executives and seasoned professionals – engineering, sales, marketing etc. – who would be good candidates to join the company or to serve on the board of directors or in some sort of advisory function. Seasoned investors also have built up a set of relationships with other investors. When it comes to follow-on rounds of funding, a seasoned venture investor acting as the lead investor can effectively assemble an investment syndicate with complementary industry experiences and investment appetite. The aforementioned relationships are invaluable to startup enterprises and take years to establish.

This article provides a hypothetical case study of how a venture firm provides the type of value-added services described above to one of its portfolio companies. While the players described here are hypothetical, they are drawn from real experiences and observations of the writer.

Let's start with the venture investor. China Venture Partners is a firm that is well established in China, having completed a number of venture deals in the TMT and consumer sectors, and achieved several successful exits via the overseas IPO markets. It is based in Beijing with a sizeable office in Shanghai. There are four partners at China Venture. Among the four partners they have a collective 50 years' worth of venture investing experience in the U.S. and Greater China. They have a mix of former investment banking experience gained at the Hong Kong offices of bulge bracket U.S. investment banks, as well as technical and operational experience gained from major U.S. technology companies. They are investing out of their second China focused fund, with over $350 million of newly raised capital to be deployed in China. They prefer early stage enterprises as they believe that is where they can add the most value, given their background and experience.

The portfolio company in this case study is Advanced Semiconductor. Advanced developed a thin film-array technology that is several times cheaper than existing technologies and not easily duplicated. The technology has potential applications in the telecom, industrial and medical devices industries. The technology was developed by a team of scientists and engineers from Jiao Tong University in Shanghai.

When China Venture first noticed Advanced, the latter was little more than a science project straight out of a research lab of a university. The team had almost no idea about the potential commercial application of the technology it had developed. Zhang Yun, one of China Venture's founding partners, had spent a decade with one of the leading semiconductor companies in the U.S., initially as an engineer and eventually moving to executive functions in various aspects of the company's operations. Mr. Zhang immediately recognized the great potential of Advanced's technology because Advanced can start with one product or market and then diversify into other product lines or markets. Even before China Venture committed to investing in the company, Mr. Zhang steered the company toward focusing on the telecom industry given Mr. Zhang's experience and knowledge that the company's cutting-edge technology could solve a fundamental bottleneck problem in the telecom



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industry. With Mr. Zhang's help, Advanced began focusing on developing a commercial application of the technology in the telecom industry.

China Venture assisted Advanced in the preparation of a business plan that can be appealing to various potential venture firms with an interest in this sector. China Venture eventually led the first institutional round of funding for Advanced Semiconductor. Under comparable circumstances, a company like Advanced would be difficult to attract venture investors because of the lack of commercial or industry experience of the team. China Venture believes three factors are crucial in delivering value-add as a lead investor. First, the lead investor must build a good team of investor syndicates in which co-investors collaborate in helping the company succeed. Second, the lead investor must know the venture market. Different venture firms have different preferences for industry segments, geographic regions and developmental stage of a company. The difference in preferred investment amounts and company building skill-sets, for example, can be substantial between early stage investors vis-à-vis growth or expansion stage investors. Finally, the lead investor must be able to execute a smooth funding process. In Advanced's case, China Venture works with the company's management team to set financing targets, identify potential interested investors, develop a convincing pitch, prepare investor-friendly due diligence materials, and lead the term sheet negotiation. Because of China Venture's solid reputation in funding promising startups in this segment and established relationship with other investors active in this sector, China Venture was able to assemble an impressive syndicate within a short time to consummate the first round of institutional funding. The capital raised - $20 million - also far exceeded the initial target set by Advanced - $4 million.

Mr. Zhang and his team were also instrumental in serving as advisors to Advanced's founder and chief executive officer (CEO), Mr. Wei Ching Tian. Mr. Wei founded Advanced while a graduate student at Jiao Tong. He had practically no experience in business, much less management. Mr. Zhang helped Mr. Wei analyze and construct a plan for the organizational and management structures for Advanced. Most importantly, Mr. Zhang stressed the priority of developing strong sales and marketing functions, rather than technology. Being a research scientist by training, Mr. Wei naturally preferred technology and oriented his company in that direction. After 6 months, it became clear to Mr. Zhang and others that the company needed a new CEO with strong sales and marketing skills in the telecom industry. To Mr. Wei's credit, he agreed to step down from the CEO position and assumed the chief technology officer (CTO) position. The relationship and trust that Mr. Zhang was able to build with Mr. Wei were critical in making this change at the top possible.

Team building is another crucial function of value-added investors. Many venture investors spend a significant amount of time – some say up to one-third - assisting their portfolio companies in recruitment matters. The best concept would go nowhere without a strong management team to execute it. Building a strong management team also entails recruiting industry experts and experienced entrepreneurs to join the company's board of directors or advisory board. China Venture helped Advanced tap into its rich network of relationships. Mr. Zhang and his team actively set up introductory meetings between various industry veterans, both in China and the U.S., and the company. As a result of these efforts, after a few months, Advanced was able to recruit a new CEO (see above), a director of strategic marketing, and a board consisting of seasoned telecom entrepreneurs and executives with experience from the likes of China Mobile, Cisco and Nortel.

The team at China Venture introduced Advanced to a number of potential major customers in the telecom industry. These are all high-level contacts who would otherwise not entertain cold calls from startups like Advanced. With the introduction by Mr. Zhang and others at China Venture, however, the CTOs at these major telecom companies were receptive to calls from and meetings with Advanced's sales team. After a series of meetings, Advanced eventually landed its first major telecom customer in China, Shanghai Mobile. China Venture's supportive role in Advanced's business development efforts is a crucial value-add. The more a startup like Advanced is able to leverage the network of contacts of its investors, the more likely the company can grow its revenue, and the higher its valuation will be in subsequent rounds of funding. By helping Advanced, China Venture also reduces its own investment risk. By introducing its portfolio companies to important contacts in the relevant industry segment or market, China Venture reaps the benefit of learning the view and opinion of veteran industry players toward the technology, products or services offered by the portfolio companies China Venture invested in. This effectively serves as a second opinion on China Venture's own judgment on the viability of a certain concept or idea. Good market reception validates China Venture's choice of investment. Market hesitation or rejection, on the other hand, would help China Venture decide whether to participate in future follow-on rounds of financing, if any. In Advanced's case, its revolutionary technology was warmly received by a number of Mr. Zhang's contacts in the telecom industry.

China Venture also introduced Advanced to a number of potential telecom industry partners. One particular aspect of value-add, when possible, is to encourage a major customer to force its supplier to make the portfolio company's new technology a component of the product or service that the supplier provides the customer. In Advanced's case, Mr. Zhang was able to convince Shanghai Mobile to make one of its suppliers, Cisco, incorporate Advanced's break-through technology into its product to Shanghai Mobile. This is a very sensible win-win strategy. Major players like Shanghai Mobile are usually reluctant to make a significant investment in a new technology that is provided by a startup like Advanced which has no track record, little revenue and a small team. Shanghai Mobile would much rather see Advanced partner with one of its main suppliers in providing the technology so as to ensure quality and continuity of service. This is obviously advantageous to Advanced. However, without Mr. Zhang's well-established relationship with the executives at Shanghai Mobile and his influence, Shanghai Mobile would not have exerted pressure on its supplier to incorporate Advanced's technology into its product.

China Venture's active assistance in fostering Advanced's partnering relationships also serves to potentially facilitate its own exit down the road. For most venture investors, exit options consist of either an IPO or a trade sale. Effective exit planning requires foresight. In the case of a trade sale, exit planning is an essential part of the venture investors' business development efforts on behalf of their portfolio companies. The larger the field of potential buyers that the investors can identify, the higher the likelihood of a successful exit. It takes time to cultivate the relationship with such potential buyers. The most likely and promising buyers are those companies who sell to the same customers as the portfolio companies, especially where the products or



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services offered by the portfolio companies are an integral part of the potential buyers' offerings. In the case of Advanced Semiconductor, given the partnership relationship between Advanced and Cisco, Cisco holds strong potential as an eventual acquirer. Advanced and China Venture would do well to continue cultivating the Cisco relationship.

The key lesson to be learned from Advanced's experience is that an entrepreneur must look beyond mere supply of capital in choosing venture investors. Rich valuation and high investment amount should not be outcome-determinative. Rather, an entrepreneur would do well to evaluate any investment proposition from a variety of value-add perspectives, as delineated above in this article. In addition to capital infusion in the monetary sense, good investors should also be prepared and able to provide intellectual capital and relationship capital to their portfolio companies.