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Clinching VC funding may get you booted from your own company

Brad Cherniak | 13/05/07 | Last Updated: 13/05/13 12:00 PM ET

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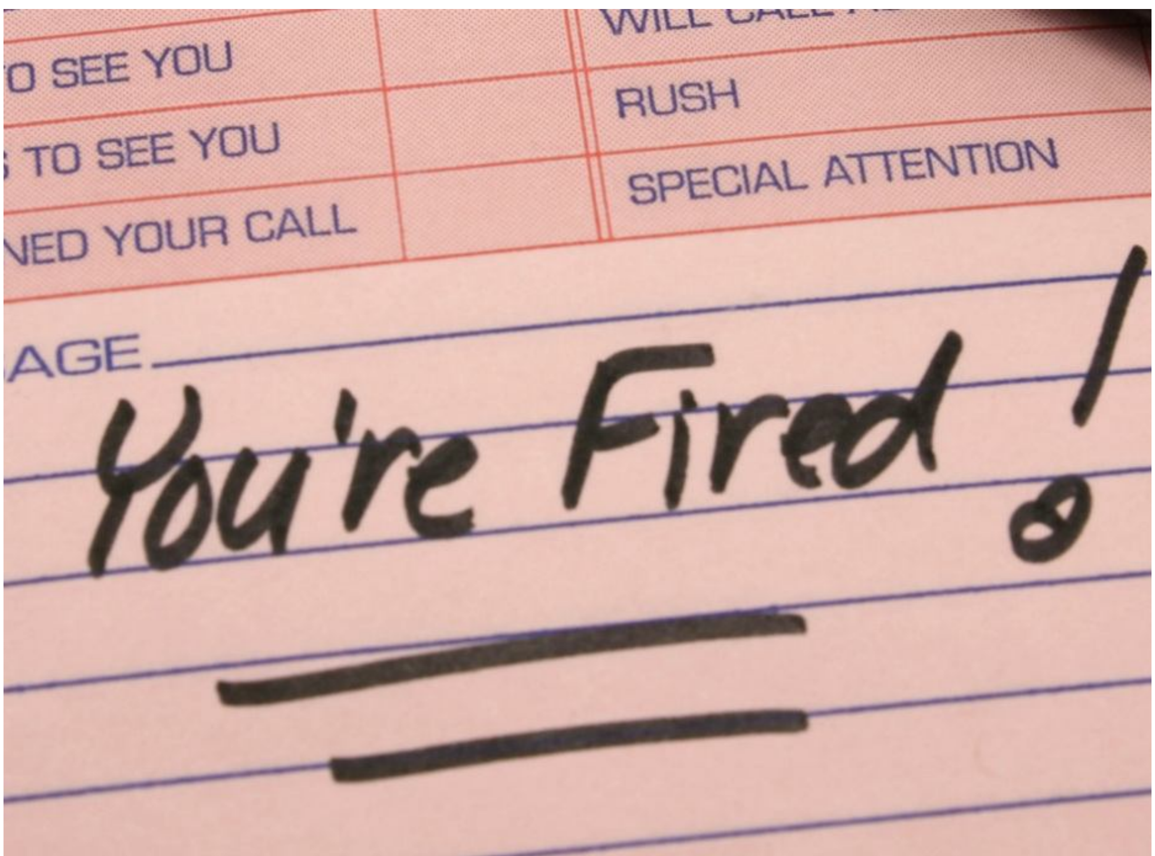

Fotolia It is generally accepted that about two-thirds of founding CEOs are removed by a venture capital fund-controlled board within five years of the initial investment.

Looking for venture capital investment for your business? If so you should know what that entails for you, the owner. That's because it is generally accepted that about two-thirds of founding CEOs are removed by a venture capital fund-controlled board within five years of the initial investment.

High-performance VCs and mid-market private equity funds appear to be in two schools of thought on why this is, and their positions tend to be strongly held.

Some investors prefer to keep the founding chief executive in place to maintain their passion and overall vision in the company, but supplement their team to fill in the founder's skill and interest gaps. In these cases, they generally remain CEO for some time, but often have a strong senior team, if not an experienced chief operating officer or president, under them.

Other investors prefer to make changes at the top when their investee companies move from one stage of development to the next, roughly as follows: early or development stage (pre-revenue, prototypes and market research); market entry/ramp stage (high growth, management/execution can be chaotic); expansion stage (more-controlled growth and execution); mature stage (end of expansion stage, growth becomes fairly nominal unless new initiatives undertaken); and repurposing/rebound stage (if the company experiences a difficulty that requires a change in strategic trajectory; can have elements of various earlier stages).

They contend the founder's passion and vision can be infused in to the company's employees, the founder's successor, and subsequent successors. These individuals will have a tailored set of experiences and skills for the particular stage of the company.

For business owners/operators with outside investors Companies looking to bring in institutional capital should speak at length with prospective investors to determine what their position is on this critical issue, and what their track record is in their portfolio. If you already have an institutional investor, this dynamic will be largely driven by them, particularly the more significant their ownership position. It will usually be documented in the shareholders agreement. Any employment agreement which has been executed by the chief executive will also be telling.

For business owners/operators with no outside investors If you are not forced to, how should you think about this concept for your own future welfare and that of your company? Presuming top-performing institutional investors are neither self-destructive nor stupid (and their track records would suggest they are neither), you ignore this issue at your peril.

Serial entrepreneur Barry Wood — who has run companies with and without institutional investors — notes that in either scenario, there is a curious paradox where the founding CEO is often the least reviewed or evaluated person in a company. This can be because of lack of communication, or miscommunication, between the CEO and the board. Or it can be a simple case of having too many other priorities to get to the CEO as a topic.

This can leave the onus on the CEO to self-assess and recognize when he or she is no longer the best person to lead the company to the next level, and is unable or unwilling to take the developmental steps to become that person.

If you don't have a board of directors or an advisory board, you are particularly prone to ignoring the signs and soldiering on. It is partly human nature and partly the drive that made you successful that makes you stay on in the face of increasing evidence to the contrary. If entrepreneurs self-assessed too much, no one would be brave enough to start or buy companies.

If you do have a functional board of some type, Wood offers the following steps to help avoid a mismatch in leadership that ultimately hurts the company:

First, there should be a formal, written articulation of the company's strategic plan that includes corporate growth objectives and the related investment and or risk appetite.

Second, there should be unanimous support for the strategic plan, and a debate if there are core disagreements. The onus here is on the board to be thoughtful and analytical, and not just rubber-stamp the owner's plan.

Third, there should be agreement on the major financial implications of the plan, such as required capital investments and additional staff, as well as any associated financing requirement and the strategy to get the funding.

Fourth, the company should articulate what the time horizon for the current owner is, and their exit or succession plan. This can clarify what the company needs and whether the current CEO's skillset fits those needs.

Finally, there should be mechanisms in place to foster candid and more timely dialogue between board meetings.

This system can result in getting the right answers to major challenges: Either making the right changes at the top in your company, or even deciding to sell to maximize shareholder value if the company is more valuable in other hands.

It will also reduce your chances of getting taken by surprise by events in your life and your business.

Brad Cherniak has spent more than 20 years as a principal, advisor to and investor in private companies. He is co-founder and partner at Sapient Capital Partners, a Toronto-based advisory firm to companies from early stage to $50-million in revenues. His column appears monthly in the Financial Post. He can be reached at brad@sapientcap.com *and you can follow him on Twitter as @SapientCapital.*