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ENTREPRENEUR GUEST

When to let your competitors be your investors

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When startups need money, they typically roll out their slide deck to the usual suspects: VCs, angels, or friends and family.

Increasingly, though, more tech and biotech entrepreneurs are looking beyond those traditional sources and seeking capital from what might seem to be an unlikely suspect: their competitors, also known as "strategic investors."

Strategic investors are operating businesses, typically in the same industry as the startups they are investing in. Therefore, they are often competitors (or could be customers) and likely a potential acquirer of that company.

Can it be risky to accept an investment from a rival? Definitely. But does it make sense? Sometimes. A strategic investment can be a smart move, provided the startup is vigilant about protecting its proprietary information, including intellectual property.

Take the money?

Soliciting funds from a competitor is an option startups explore when they fear that VCs will be too grabby. I worked closely with founders who didn't want to give a majority stake in their company to investors or give investors the last word on certain major business decisions. These founders feared that VCs would insist on control of the stock and key decisions.

These founders raised money from strategic investors, including a larger company in the space that understood the startup's business. Though it might seem ironic or contradictory, the founders felt that their strategic investors — the competition — were invested in their success. The founders' reasoning was that their startup would be a strong acquisition target, and the strategic investors would be well-positioned to buy it. (The investors were likely harboring the same thought.)

Another benefit to taking on a strategic investor is the potential to enter into a joint development agreement or similar collaboration. This arrangement gives the strategic investor rights to acquire or license the startup's programs or products. That creates two potential upsides: The development of a program or product can be fast-forwarded, and it's seen by people who will understand its value. This sounds like a win-win arrangement. However, a startup must carefully weigh the risks involved in taking money from a competitor.

Kicking the tires, and more

Liberally granting insider access to a potential acquirer can put an early-stage company at a competitive disadvantage. The strategic investor can obtain access to sensitive information shared in meetings or confidential material in company documents. It can inspect records and will receive financial statements. Instead of merely kicking your startup's tires, you may find your strategic investors want to poke around under the hood, too.

Further, lead investors often insist on obtaining board seats in exchange for their capital. That gives them what amounts to an all-access pass to board meetings, where they are privy to closely guarded strategic and sensitive information, including any business struggles or disputes. Even when investors do not obtain board representation, they

often insist on the right to observe board meetings and review the same materials provided to directors.

Of course, VCs and other financial investors can access the same proprietary materials and can take board seats or receive board observation rights, too. This access, however, does not involve the same level of risk because VCs and other financial investors, unlike strategic investors, aren't operating businesses in the same field as their portfolio companies. Rather, their business is the business of investing.

Protect and defend

If you're raising capital from strategic investors, protect yourself by negotiating hard on what you'll share and reveal. To protect your startup from operating at a competitive disadvantage, insist on the right to exclude an observer from a meeting or redact or withhold certain documents from the investor. Compelling reasons to limit a strategic investor's access to your inside information are:

- If the information is a trade secret
- If sharing the information would interfere with your relationship with your lawyers (attorney-client privilege)
- If disclosure would create a conflict of interest with the strategic investor
- If the information relates to a relationship with competitors of the investor
- If disclosure would cause competitive harm to your startup

Think it through

Another risk to consider is whether potential investors are in it for the long haul. VCs typically plan to invest in multiple rounds of financing, but a strategic investor may be

more fickle. Its business strategy or priorities may shift — which is not uncommon in tech, biotech, or other innovative industries — and its focus may diverge from your startup's interest. If that's the case, you may need to devote precious time and energy to raising capital from new investors. Had you stuck with securing funds from VCs, you might have avoided this.

Taking money from a potential acquirer or competitor requires founders to weigh the risks of granting access to their startup's inner workings. Fortunately, entrepreneurs aren't new to balancing risk and reward. So weigh the pros and cons and then take the money — or run.

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