to be an exhaustive guide for structuring PE funds. Appropriate tax, legal and other professional advice should be obtained prior to the setup of a PE fund and preparation of the underlying transaction documents.

2. Venture Capital

[2-38] Venture capital (**VC**) sometimes is seen as a subset of private equity. The investors include angel investors, high net-worth individuals, venture capital funds, insurance funds and corporate investors. This is a common form of financing for start-up companies. As many start-up companies are engaged in novel industries or have innovative business models, they often lack a long and strong track record of successful operation. Hence the risks of VC investments are much higher. To leverage the higher risks against the potential of a high-yield return, VC investors often invest in dozens of companies with perceived long-term growth potential, betting that a few of them will generate massive returns in the future to compensate for the losses in other investments.

[2-39] VC investments have become increasingly popular since the 1990s. Today Hong Kong is one of the most popular VC markets in Asia. The Hong Kong government has established government-sponsored VC funds to finance innovative industries and entrepreneurship. The Innovation and Technology Fund (**ITF**) was set up by the Hong Kong government in 1999 with an initial injection of HK$5 billion. Currently, there are four support programs under ITF: The Innovation and Technology Support Program, the General Support Program, the University– Industry Collaboration Program and the Small Entrepreneur Research Assistance Program. As of 31 July 2015, there were 4,675 approved projects under these programs and the total investments amounted to HK$9.5786 billion so far.

2.1 Benefits of venture capital

[2-40] *Sources of financing for start-up businesses*: without a sufficient track record of operation, it is difficult for start-up businesses to attract financing by traditional means like bank loans. Lenders tend to be conservative and will not agree to lend without obtaining sufficient collateral security from the borrower and its shareholders. On the other hand, VC investors are more willing to take investment risks in return for higher returns and acquiring a higher percentage of the ownership of a company and right to participate in its business management.

[2-41] *Strategic value*: VC investors are usually professional and institutional investors. Their participation in the ownership and management of start-up businesses, such as appointing directors to the investee company's board, can bring in management, technical and financial expertise that is invaluable to new business ventures.

[2-42] *Networking*: VC firms, especially those with regional and global presence, can introduce start-up companies to the VC firms' extensive network of domestic and international business partners.

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[2-43] *Facilitation of future financing*: obtaining investments from a reputable VC firm can enhance the creditability of the investee company which can facilitate the company's future fund raising plans.

2.2 Certain setbacks

[2-44] *Expensive financing costs*: considering that the VC firms are usually professional investors and the investee company is at its start-up stage, the costs for the founders and the company to negotiate and secure VC financing, including selling substantial equity interest and paying fees for their professional advisers, can be comparatively high.

[2-45] *Time consuming*: closing a deal with a VC firm can be a relatively long and complex process. A detailed business plan with financial projections of the investee company is usually required by the VC investors before they are persuaded into investing. The negotiation process can be lengthy.

[2-46] *Potential loss of control*: VC investors tend to require a controlling interest in the investee company and may want to take a significant equity position, including preferred shares with preferential rights and stringent anti-dilution provisions, and the right to appoint their nominees as directors to the board.

2.2.1 Steps of venture capital investment

(a) Preliminary stage

[2-47] Presenting a good business plan is essential as it aids the VC firms to evaluate the pros and cons of investing in a start-up company. A business plan usually comprises of:

(a) a comprehensive overview of the background information of such company and its business;
(b) information on such company's key management members including their skills, experience and achievements;
(c) the company's business goals and strategies in view of the market outlook;
(d) financial analyses and projections; and
(e) funding requirements and proposed use of proceeds.

[2-48] Apart from the business plan, the VC firms may request further information from the founders and the management team during the initial negotiation stage. The parties can enter into heads of terms to record their key understanding and material terms of the proposed investment. To protect their interests, the founder and the investee company can request confidentiality, non-competition and non-solicitation undertakings from the VC firms. The VC firms can ask for exclusive undertakings from the founder and the investee company. These can be covered in the heads of terms or by separate agreements.

[2-49] For further information on heads of terms, see **[3-48]-[3-57]** in Ch 3.

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(b) Due diligence

[2-50] The purpose of due diligence is to obtain more information about the investee company to enable the VC firms to evaluate the benefits and risks of the proposed investment. The VC firms may engage professional advisers and experts in the due diligence process including legal advisers, financial advisers and technical experts. Based on the due diligence results, a VC firm can decide whether to proceed with the investment and consider the investment terms and amount.

(c) Main transaction documents

(i) Subscription and shareholder agreement

[2-51] A subscription and shareholder agreement, or 'investment agreement', is an agreement between the existing shareholders and the VC investor. The investee company will usually be a party to the agreement so that it will be bound by the transaction terms. Typical terms of the subscription and shareholder agreement include:

(a) the amount of investment to be made by the investor and the number and type of shares to be issued to the investor in return;
(b) conditions precedent to the closing of the transaction;
(c) representations and warranties of the investee company and its business and affairs; it is common for the representations and warranties to be qualified by the disclosures made in the form of a disclosure letter by the other shareholders and the company; and
(d) covenants, undertakings and indemnities given by the existing shareholders and the investee company in favour of the investor.

[2-52] The subscription and shareholder agreement also delineates the relationship, rights and obligations among all shareholders including the investor. VC investors usually insist on preferential rights to be attached to their shares. These preferential rights may include:

(a) *pre-emption rights*: shareholders are not allowed to transfer their shares to any third party unless they have first offered their shares to the other existing shareholders under the same terms;
(b) *voting rights*: the VC investor, as convertible preferred shareholder or creditor, has the right to vote in ordinary shareholders' meetings on an as-converted basis. Some convertible preferred shares or debts contain special voting rights with respect to corporate decisions outside its normal course of business;
(c) *tag-along and drag-along rights*: the VC investor is given the right to 'tag-along' if the founder or majority shareholder sells its shares to a third party. In such cases, the VC investor can require the potential buyer to buy a portion or all of the VC investor's shares under the same terms and conditions as the other shareholders. 'Drag-along' rights permit the VC investor to require the other shareholders to sell their shares to a third party buyer together with the VC investor.

These rights enable the VC investor to exit easily in the case where the other shareholders or the VC investor wishes to sell their stake in the company;

(d) *co-sale right*: if a shareholder transfers a portion of his or her stake to a third party, the other shareholders are entitled to transfer part of their shares to that third party on a pro-rata basis and under the same terms;

(e) *anti-dilution*: the VC investor will require the investee company to obtain its prior consent before issuing any new shares to prevent its equity stake from being diluted due to an increase in share capital. Along with its prior consent right, the VC investor can be given priority to subscribe for the new shares; and

(f) *ratchet*: to encourage the management team of the investee company, which usually comprises of its founders, to perform at its best and maximize the value of the company, VC investors can offer ratchets to the management team as performance incentives. It permits the management team to gain a higher equity stake if the company's performance exceeds certain targets within certain time frames. This equity bonus may yield higher gains to the management team compared to ordinary monetary bonus schemes. Therefore, it can be a selling point for a VC investor when competing with other potential investors. Under the appropriate circumstances, the management team can sell their shares to realise their investment value and enable the VC investor to exit its investments as well.

(ii) Memorandum and articles of association of the investee company

[2-53] The CO stipulates that the memorandum and articles of association of a company has the binding effect of a contract between the company and its shareholders and among the shareholders *inter se*. It is deemed to contain covenants on the part of the company and each shareholder to observe all its terms. In order to bind the investee company to the terms of the subscription and shareholder agreement, the VC investor often will require the investee company to amend its memorandum and articles of associations to incorporate the essential terms and rights of its investments. Some common amendments include:

(a) creation of preferred shares as a new class of shares which can contain convertible rights into ordinary shares at the option of the VC investor and under certain specified circumstances such as a 'qualified IPO';

(b) provisions relating to conversion price or ratio of the preferred and convertible shares and adjustments thereof;

(c) provisions relating to mandatory redemption of the shares of the VC investor by the investee company if it has not been sold or gone public within a certain period of time; and

(d) provisions relating to dividend policy and rights of different classes of shares including voting rights and preferred rights to distribution upon the company's liquidation which includes an industrial sale.

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(iii) Tax indemnity

[2-54] A tax indemnity is usually required by the VC investor to protect the value of its investment against any tax liabilities which have not been provided for in the investee company's accounts.

(iv) Service agreements

[2-55] Unless already in place, service agreements must be executed between the investee company and its founders to formalise the founders' employment relationship with the company.

(v) Shareholders and director's resolutions

[2-56] Pursuant to the requirements under law and in the memorandum and articles of association, shareholders and directors have to pass the necessary resolutions in order to:

(1) reorganise the company's share capital structure;
(2) issue new shares;
(3) amend the memorandum and articles of association; and
(4) agree to the execution of various agreements and transaction documents and the consummation of the transactions and matters contemplated thereby.

(d) Exit strategies for venture capital

[2-57] Given the higher risks associated with VC investments, VC investors usually bargain for exit terms most favorable to them as a precaution in case the investee company fails, which allows them to maximise their chance of selling their stake at a reasonable price. Exit terms can include the previously discussed tag-along and drag-along rights and preferential treatment upon liquidation. In case of an insolvency liquidation, as a general principle, the priority of claims of the VC investors as preferred shareholders is subject to the claims of secured creditors and preferential creditors.

[2-58] On the other hand, if the business venture turns out to be a success, the VC investors can realise the increased value of their investments through other means such as forced buyouts, trade sale and initial public offering.

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