

What's Exactly “Ventures' Betting on Performance”, the Counterpart of Equity Ratchet in China

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Abstract: The “Ventures' Betting on Performance” has been applied in China's private equity and venture capital investment circle for more than a decade. However, people do not have clear understandings on its unique attributes which can distinguish it from other venture capital contracts; they cannot identify contracts types that belong to “ventures' betting on performance”. This paper reviews three types of contracts allegedly referred to “ventures' betting on performance”, namely “Valuation Adjustment Agreement”, “Performance Commitment or Compensation” and “Equity Ratchet” Agreements, and compares ventures' betting with traditional venture capital investment contracts based on convertible preferred stocks, showing that the distinct characteristics of “ventures' betting on performance” lie in the high-level risk exposure and high incentive intensity for both investors and investees. The comparison of “ventures' betting on performance” with “Earn-out” demonstrates that venture capital contracts are in a continuum; they usually have subtle differences in their boundaries. This article can provide reference for academic researchers and industry practitioners in identifying and selecting venture capital contracts.

1. Introduction

Ventures' Betting on Performance is a unique risk contract mechanism in China. In practice, a large number of entrepreneurs lose control of their enterprise due to the failure of betting, resulting in the loss of wealth and men. Therefore, the betting agreement bears the reputation of depriving entrepreneurs' control power and destroying the development of enterprises. However, the role of new financial contracts in matching transactions, optimizing resources and supporting entrepreneurship and innovation can not be ignored. They help China's industrial upgrading and economic transformation. In the tide of “mass entrepreneurship and innovation”, the research on ventures' betting is particularly important.

Although the use of ventures' betting has been established by convention, people do not have clear understanding on that agreement. Some investors and entrepreneurs do not understand the difference between ventures' betting and other risk contracts; even some academic researchers mistakenly equate ventures' betting with valuation adjustments. From the perspectives of contract economics, the mechanism design^[1-2] and real options^[3-5], researchers have carried out theoretical analysis on the functions and mechanisms of ventures' betting. In addition, the existing research includes the case analysis^[6] on the betting process, as well as a few statistical empirical analysis^[7]. Generally speaking, the existing research lacks the dialogue with the traditional venture capital contract theory. Based on the exploration of local phenomena, the research on ventures' betting forms the state of “knowledge fragments”. There are several basic questions to be answered for the research: what is ventures' betting on performance? What is the fundamental difference between it and other venture capital contracts? What types of contracts does it include? Financial instruments are structured in “one continuum” rather than an exact category, so it is difficult to define them clearly^[8]. This paper finds that the betting agreement is not separated from the basic logic of the traditional VC contract design, but it does have greater risk exposure and strong incentive effect; the feature of “gambling” is very obvious. This paper compares several major risk contracts by literature research, trying to reveal the characteristics of ventures' betting on performance in China's specific environment.

This paper first points out that there is no uniform professional title for ventures' betting on performance, and then reviews and analyzes three types of contracts referred to as ventures' betting, and summarizes their common points. Afterwards, referring to the traditional venture capital contract,^[9] this paper discusses the essential characteristics of ventures' betting on performance. Finally, comparing with the “Earn-out” plan, we try to identify the boundary between ventures' betting on performance and other contract forms.

2. Lack of Commonly Used Professional Title for Ventures' Betting on Performance

Various domestic literature has different expressions on ventures' betting on performance: gambling agreement, performance compensation, performance commitment and compensation, profit commitment compensation, adjustment based on performance^[10], valuation adjustment mechanism and so on. The public often call it as “ventures' betting”; investment banks, private equities and securities regulatory departments use “performance commitment or compensation”; judicial and management researchers often call it as “valuation adjustment agreement”. Many people in China think that betting is a foreign product, but few foreign documents record it. Some experts claim that “there is no ventures' betting in Silicon Valley”^[11], believing that betting is the creation and invention of foreign investment banks in China's institutional environment. However, through repeated model comparison, this study finds that the operation mechanism of “equity ratchets” of overseas private placement is highly consistent with that of “valuation adjustment agreement” or “performance commitment or compensation” in China; it is also considered as ventures' betting by a few domestic scholars^[12].

3. Analysis and Comparison of Various “Ventures' Betting on Performance”

“Valuation adjustment agreement”, “performance commitment or compensation” and “equity ratchet” have their own characteristics. Firstly, the paper analyzes the “valuation adjustment agreement”. “Valuation adjustment agreement” refers to an agreement between the investing and financing parties to adjust the prior valuation of the enterprise and the proportion of prior equity distribution according to the actual operation of the enterprise. During the initial financing negotiation, the investing and financing parties putting aside disputes on valuation, and preset a valuation level and corresponding equity proportion. After the operation results are generated, they calculate the actual valuation and the proportion of equity, and then increase or decrease the prior rights and interests of each party accordingly. This is a narrow understanding of ventures' betting. After the “buyback clause” is added, it becomes the most common ventures' betting on performance, which belongs to a medium understanding. It's difficult to use the literal meaning of “valuation adjustment agreement” to refer to it^[13]. In the existing Chinese literature, there is also a commonly used definition. “Valuation adjustment agreement” is agreed by both parties; “if the future profitability of an enterprise reaches a certain standard, the financing party has certain rights to compensate for the loss of undervalued enterprise value; otherwise, the investor has certain rights to compensate for the loss of overvalued enterprise value.”^[14] This is a relatively broad definition, which generally refers to venture capital contracts^[13].

Secondly, the concept of “performance commitment or compensation” is analyzed. According to the existing research, “performance commitment or compensation” is a kind of contract reached by both parties to deal with the uncertainty in the future in the financing merger and acquisition^[15]. The specific meaning is shown in *Commission in Measures for Administration of Material Assets Reorganization of Listed Companies* regulated by the China Securities Regulatory. For listed companies purchasing assets, the acquired companies need to provide the profit forecast report of assets to be purchased (or listed companies after purchasing assets) in the future period, and disclose the difference between the actual and forecast profit of relevant assets within 3 years after the asset acquisition, so as to sign a clear and feasible compensation agreement; the listed company shall bear the compensation responsibility^[16]. It can be seen that it is a protective contract established to protect the interests of listed companies as well as small and medium-sized

shareholders from benefit lost due to inaccurate prediction of asset restructuring ^[17]. In start-up financing, venture capital institutions use “performance commitment or compensation” are often suspected of lacking post investment management ability; they are “lazy” and adopt the simple method of investment management afterwards ^[18].

Finally, the overseas prototype of ventures' betting, namely “equity ratchets” in English is analyzed. Researchers often think that “ratchet” is a valuation adjustment mechanism, which is realized through the price adjustment. When entrepreneurs fail to achieve their promised financial goals, they need to compensate investors with shares; otherwise, venture capitalists can get a part of entrepreneurs' shares ^[19]. It not only protects venture capitalists from downside risks, but also encourages entrepreneurs to obtain upside benefits. Therefore, it is different from the “anti dilution ratchet clause” which only contains downside risk protection regulation. For entrepreneurs, downside risk is a negative incentive, which is different from the positive incentive of options ^[19]. The assessment objectives of equity ratchet agreement can also be non-financial, such as “obtaining the qualification for public listing” ^[8]. Equity ratchet agreement can be designed as a contract method to achieve different goals. If it is arranged according to a gradual spectrum, and if one of the target endpoints is used to solve valuation differences, the other endpoint will be used for the performance incentive ^[8]. In essence, it is a kind of contingent contract, which links the shareholding ratio of managers with performance and solves the problem of interest incompatibility ^[20].

To sum up, the internal mechanisms of the three types of contracts are highly consistent. They can be regarded as a contingency arrangement for dealing with contingency events in the future, and the interests of the two parties can be adjusted through ex post adjustment. However, in their respective fields, they have different emphasis.

4. Characteristics of Ventures' Betting on Performance: Difference from Traditional Venture Capital Contracts

The betting agreement has clear stipulation on the adjustment of contingent interest, which enhances the “self performance” ability of the contract and reduces the dependence on renegotiation and third-party arbitration. However, this does not make it different from the traditional venture capital contracts based on convertible preferred shares. Preferred stock is essentially an option. From the perspective of the structure of traditional venture capital contracts, the cash flow right, the control right and the exit right are the three basic components ^[21]. It also follows the investor protection principle of “downward risk protection and upward revenue sharing” ^[22]. The rights of both sides of investment and financing are unequal, and venture capitalists have the privileges of priority liquidation and forced redemption.

So, what are the characteristics of ventures' betting on performance? Compared with traditional venture capital contracts, it has a strong feature of “gambling” because of the leverage income and the time bet. Foreign venture capital contracts generally take the convertible preferred stocks as the core, adjust the conversion price in advance, have the upper limit protection of equity ratio as well as anti dilution clause to protect the follow-up rights and interests, and have a reasonable preset for the control right of enterprises. If the enterprise is not well managed, the entrepreneurs need to compensate the original capital of investment and basic interest; the bankruptcy protection law for small and medium-sized enterprises provides protection for entrepreneurs and reduces their risk losses. Comparatively speaking, the positive and negative incentive effects of betting are very large, which often lead to great disparity in results. When the betting object is equity, the failure of gambling will deprive the control right of the entrepreneur, while the investor will increase the risk exposure after obtaining the compensation shares. When the gambling object is cash, the enterprise tends to fail when the enterprise is short of funds. The withdrawal of operating funds can lead to the rupture of the capital chain. It can be seen that ventures' betting often leads to the loss of both sides of investment and financing. The word “betting” in the name of gambling agreement reflects its essential characteristics of high motivation and high risk.

5. The Fuzzy Boundary between Risk Contracts: Taking Ventures' Betting on Performance and “Earn-out” as the Example

Earn-out is a commonly used contract mechanism in foreign countries, which is called as “profitability payment plan” by domestic researchers^[18]. As a pricing and payment mechanism, it is similar to “contingent consideration”. Only after reaching the preset goal, the residual payment will be paid^[23]. Due to the inability to realize the value of the acquired enterprise, the acquirer is worried about the unstable operation of the enterprise after the equity delivery. The acquirer prepays part of the consideration and reserves a small amount as the margin. The original management team of the company is required to continue to participate in the operation of the enterprise, and the remaining part will be paid only after they pass the assessment. Earn-out is widely used in strategic mergers and acquisitions in the United States, and is mostly used in the biomedical industry which is difficult to value^[18]. In recent years, some Chinese companies carry out overseas merger and acquisition. Most of them adopt the way of profitability payment plan because the foreign company does not accept the method of venture's betting^[23].

Because it is a contingent consideration to deal with the future, some people think that the profitability payment plan belongs to a type of venture's betting. However, after comparison, it is found that there are subtle but fundamental differences between the two. First of all, although the profits are all paid in installments, the profits of the invested entrepreneurs in the betting agreement are uncertain. The acquiree in the profit payment plan collects the purchase price in advance, and only a small part of the margin is uncertain. Secondly, the information asymmetry and the agent problem are more serious in venture's betting. The acquirer in the profit payment plan has fully mastered the right of operation and control, and the profit payment plan is only a contractual tool to ensure the smooth transition of enterprise operation and reduce losses^[23]. It can be seen that the fuzzy boundary between the risk contracts is not easy to detect. Although the Earn-out plan and the gambling agreement both have the basic economic logic and contract characteristics of the traditional venture capital contracts, the incentive and risk effects brought by the differences in the income structure of the two in the specific process are quite different.

6. Conclusion

This paper analyzes the venture capital contracts related to ventures' betting on performance, and summarizes their common characteristics. It reveals the characteristics of gambling of ventures' betting by comparing it with the traditional venture capital contracts. The paper also finds out the subtle and important boundary between ventures' betting and other risk contracts by comparing it with the earn-out plan, so as to provide a systematic analysis on the mechanism of ventures' betting, and provide reference for practitioners to understand the essential characteristics of ventures' betting. Now in China, entrepreneurship and innovation are in full swing; the incentive cooperation of various stakeholders is the key. The incentive contract tools, including ventures' betting on performance, are worthy of further exploration by the financial industry and scholars.

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