January 01, 2013

Of Milestones and Millstones

High-impact entrepreneurs and their investors as often as not have different takes on the all-important valuation question. Entrepreneurs, of course, tend to focus on what can go right about a deal, while investors tend to spend more time thinking about what might go wrong with a deal. Finding a mutually agreeable middle ground – and valuation – is thus quite often problematic.

One strategy for bridging the valuation gap is milestone-based financing. With milestone financings, the parties agree that an initial tranche of financing will be followed by a subsequent tranche based on the company achieving (or not) some milestone. The second tranche might be contingent on achieving the milestone; alternatively, the valuation of the second tranche might be contingent on whether the milestone is achieved. Reasonably sophisticated readers, like mine, can imagine a variety of variations on the milestone financing theme.

Milestone-based financing has been around for quite a while, and why not? In theory, it seems like the kind of creative approach to problem solving that high-impact entrepreneurs and investors pride themselves on. Alas, if you have been in this business as long as I have, you will likely conclude, I think, that milestone-based financing usually, if not always, causes more problems than it solves, for one or more of the following reasons.

First, defining milestones is not always as easy as it might seem. Just how flawed, for example, can a minimally viable product be and still be deemed to satisfy a milestone that the company release its first product to the market? Too often, in the interest to bridge the valuation gap and closing the deal, entrepreneurs and investors find milestones that they agree on because, well, they both have a different understanding of what their agreement means in terms of what constitutes achievement of the milestone. Probably the least of the problems with milestone financing, but one that has tripped up more than a few startups.

A second problematic aspect of milestone-based financing manifests itself when a milestone is set too far in the future. Entrepreneurs and their investors may think they know what they want the enterprise to be when it grows up, but if the history of high-impact startups tells us anything it tells us that startups seldom mature into the businesses their founding teams envisioned. As the environment around a startup evolves, so too the startup itself will need to evolve – likely in a way that makes some mid- to long-term milestone that made a lot of sense at launch look less than appropriate before it is (or is not) achieved. And yet, having been set, the milestone will take on a reality-distorting life of its own.

Finally, milestone-based financing is simply antithetical to the world of the high-impact startup. Milestones are useful on routes that are well marked and durable (thus the term’s roots in the road networks of ancient Rome). Having been in and around the high-impact entrepreneurship and investing space for almost 30 years, I can’t recall the last startup that followed a well marked and durable route from conception to exit. The high-impact startup environment is, instead, known for fast-paced and unpredictable change; for being an environment where today’s best take on how to apply limited resources to achieve success might (probably will) look wholly inappropriate – if not to everyone, at least to some of the key players – next year, next month, next week, or even the next day. But once the milestone is set, and something as crucial as the next critical slug of capital is tied to it, it will take on a life of its own; a life that will likely be a major management distraction at best, and a company killer at worst.
Now, there are cases, I suppose, where milestone-based financing is a good, well, acceptable, approach to bridging disparate entrepreneur/investor takes on valuation. But, in my view, they are few and far between. If you think your deal is one of the exceptions where milestone financing makes sense, be sure and pick near-term milestones that can be very precisely defined – and then cross your fingers that your company, and the market dynamics that shape its future, stay aligned with the milestone at least until it is achieved.

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