Deal-Making and University Spin-outs: An Examination of Perceptions, Processes and Outcomes Affecting Deal Success

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Principal Topic This paper examines factors that contribute to successful deal-making for university spin-outs in the United Kingdom (UK). Although previous studies identify constraints to deal-making arising from issues over ownership claims, transfer and licensing of IP and access to private investment, few studies have examined actual deal-making processes, deal structures and deal outcomes or the perceptions of key players involved in spin-out deal-making - universities, spin-out founders and investors. The paper responds to the need for further study on understanding the deal-making process and how it affects the formation and subsequent success of university spin-outs.

Methodology/Key Propositions The paper draws upon four levels of analysis. The first level examines files of 17 spin-out deals brokered by a prominent UK legal firm. Seven deals were brokered with the client as a spin-out founder and 10 deals where the client was an investor (four different investors are represented among the 10 deals). A deal-making template is developed to review each file and to facilitate comparisons between deals. The template includes spin-out profile, identified shareholders and directors, contracts, financial and investment criteria, intellectual property (IP) and other assets, professional service provision and fees, management structure, deal structure and ‘contentious issues’.

The second level examines results of a survey sent to 150 spin-out founders that makes explicit the actual spin-out deal, post-deal activity and subsequent performance of the spin-out. The survey’s 60 questions also examine factors contributing to spin-out formation, professional service provision, the deal structure and contentious issues.

The third level examines university technology transfer office policies and deal-terms related to spin-outs, drawn from interviews with directors of 25 technology transfer offices. The sample includes 9 Scottish Universities and 12 of 19 UK Russell Group (leading research-intensive) universities (including Edinburgh and Glasgow) with three US universities and one Canadian University used for comparison purposes.

The fourth level examines the perceptions of investors of UK university spin-outs. A questionnaire and semi-structured interview are administered to 5 investor groups active in spin-outs as well as 3 key groups in the investment sector involved in funding and business support for university spin-outs.

Results and Implications Findings identify that primary contentious issues between founders and universities are the terms upon which IP is to be transferred to the spin-out company and the size of the university’s equity stake. Universities suggest they are not amenable to relaxing compulsory transfer provisions affecting founders or negotiating away from original positions on equity stake and royalty rates. However, approximately 65% of the founders in the spin-out survey identify that the university did not seek to protect their equity interest against dilution when external investment was being secured. Investors were mixed in their willingness to negotiate their equity stake to reach a compromise position between themselves and spin-out founders.

Findings show that spin-out founders generally seek to negotiate the level of their liability downwards in deal negotiations and over-estimate the value of their IP. Indeed, investors identify valuation of IP as one of the most contentious issues in deal-making with founders and universities. Investors suggest that sole reliance on value of IP or a patent in negotiations eventually weakens the bargaining position of founders and universities, as investors negotiate on the basis that these parties are not able to translate IP into commercial application without investor support. Investors were mixed in terms of valuation for the purposes of negotiating deal
terms, ranging from using a model of discount to peer groups in the context of current market conditions to the potential exit value of the company and risks to exit.

Two out of three founders in the survey obtained their own legal advice prior to initial deal terms agreed with the university, but the majority of founders only took legal advice when they had already decided upon the preferred route of technology exploitation and level of investment sought. In most cases, founders had informally negotiated deal-terms with relevant parties, included terms of a license.

Findings confirm an underestimation in the amount of legal advice founders require that has implications in relation to deal terms having to be renegotiated at the stage of legal advisers being instructed. But two other effects are identified: 1) there are common time requirements for conclusion of a deal that are often not met; and 2) founders set unrealistic targets in respect of the anticipated date of deal conclusion on the basis that they consider that 'all the groundwork on the deal has already been completed'.

The implications here are important, for the study finds that the anticipated and actual date of deal conclusion is driven by demands of relevant investors. The need to complete deals quickly is identified with outweighing the most favourable deal terms for founders. Founders therefore face the prospect of lower valuations by investors in addition to a set of sometimes difficult negotiating conditions that include placement of service contracts for each founder, future investments tied to founder performance and company milestone achievements and re-location of the spin-out company to a favourable site.

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