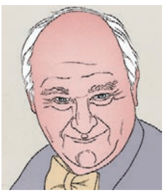
Case Study

An Angel Investor with An Agenda

Should a health care entrepreneur accept €3 million from someone who wants a say in all strategic decisions?

by Regina E. Herzlinger and Beatriz Muñoz-Seca

The Experts



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HBR's fictionalized case studies present dilemmas faced by leaders in real companies, and offer solutions from experts. This one is based on the HBS Case Study "Vitalia Franchise" (case no. 311035), by Regina E. Herzlinger and Beatriz Muñoz-Seca. It is available at **hbr.org**.

Gloria Londoño scanned the tables at the Opera restaurant. Victor Serna was sitting at one in the corner, drumming his fingers on the white tablecloth. She caught his eye and gave a small wave. Victor nodded but didn't smile.

This was their third meeting in a month. The first had been at a small cocktail party hosted by mutual friends. She'd mentioned her business, Calidad de Vida, a group of day care centers for the elderly, and he'd peppered her with questions, explaining that he was interested not only as a doctor (he was the leading cardiothoracic surgeon at Madrid's best hospital) but also as a potential investor (he'd unloaded his stocks just before the market collapsed).

Gloria wasn't necessarily looking for new funding, but she was glad to have made the contact. When Victor called her office a few days later, asking for a tour of her flagship center in Madrid, she was intrigued. She took him around the 7,500-square-foot facility the following week and told him even more about the business. After two hours, he asked her to meet him for lunch in a fortnight. She agreed and proceeded to canvass their common contacts to learn more about him.

Victor came from a wealthy family but was also independently rich, from both his thriving medical practice and his investments. Aside from stocks, he dabbled in an activist brand of angel investing, holding large stakes and board seats in several start-up health care businesses, all based in Spain. He had two ex-wives, a 25-year-old girlfriend, and no children. His suits were Gucci, his watch Patek Philipe.

He was looking at the watch as Gloria sat down. "Prompt—that's a good sign," he said. "I was here a few minutes early, so I already ordered us Serrano ham and Rioja. I had two surgeries today, but now I can relax. Have you eaten here before?"

"Yes, once," Gloria said. "It's lovely."

"I come perhaps twice a week. They do a good job." He motioned to a waiter, who hurried over to pour them glasses of sparkling water and then retreated silently. "So, before the food arrives, let's get the business out of the way. As I'm sure you've guessed, pending review of your financial statements, I am ready to invest in Calidad de Vida. Three million euros."

Gloria's heart leaped, but her expression remained calm and confident.

"That sort of money should allow you to open 10 new centers next year, not through franchising, as you'd planned, but under your direct ownership and control. In return, I would want a 25% stake, a board seat, a vote on all strategic decisions, and the ability to liquidate my position in five years, should I so choose, through either a public offering or a sale."

Gloria started to respond, but he cut her off. "My lawyers have drafted a contract." He pulled a document from his briefcase and handed it to her. "Take it home. Read it. Let me know by the end of the week." He beckoned to two more waiters standing nearby with a platter of sliced ham and a bottle of wine. "Now let's eat and talk about something else."

Down from Heaven, Back to Earth

Gloria walked briskly from the Opera to the nearby Jardines de Sabatini. She and Victor had chatted casually about everything but business at lunch—if he didn't want to discuss the offer, she certainly wasn't going to reveal how excited she was by pressing the issue. But she couldn't wait to review the contract.

She found a bench and pulled the document out of her purse. It recapped, in legal language, what Victor had told her. His money would allow her to pursue a new, perhaps more comfortable, growth strategy, directly managing 10 new centers rather than franchising them as she'd done with 11 of the 12 existing Calidad de Vida locations. But the price of gaining that control would be ceding some to him—her own stake would fall from 64% to 51%—and he would have more involvement in the business than any one of the friends and family members who had invested with her thus far.

She would need to discuss the offer with her colleagues and her board very soon. But first, she decided to stick to her plan to visit the nearby center after lunch. The director wasn't expecting her, but Gloria liked popping into the franchises unannounced to get an unvarnished view.

She stood outside the building for a moment, peering into the big glass windows at six elderly clients seated around a table in Calidad de Vida's signature green chairs. They were listening intently as an instructor led them through a memory exercise.

This scene was what she'd envisioned five years before, when she quit her job as an occupational therapist to enroll in a health care management course and, later, business school. Her goal had been to create an alternative to the traditional nursing home, a place where seniors with various disabilities could come for the day and be rehabilitated through individually tailored activities. In different rooms, groups might be doing physical or music therapy. The staff-to-patient ratio was 1 to 6. Hours were flexible. Families were deeply involved in developing treatment programs. And the approach was consistent across all the franchises: The company used proprietary methodology, therapy-management software, electronic patient records, and strict performance protocols to ensure uniformity, although Gloria knew that some centers outperformed others.

"Gloria! So good to see you!" Paola Silva, the always cheerful center director, greeted her as she walked through the door. "I was just on the phone with Jorge telling him to call you," she said, referring to the franchise owner, Jorge Patriño. "We've had four new clients sign up this week, all full-time. Can you believe it's taken us only nine months to get to 35 clients?" That was the break-even target for a new Calidad de Vida franchise, and it typically took a year.

"That's terrific," Gloria said. "I'll walk around, if you don't mind. Are there any family visits I can observe?"

"Yes, Dr. Chavez just sat down with a client and his granddaughter. We can walk in quietly and stand in the back."

"So, Señor Pico, I'm going to say five words. Please repeat them for me: ball, tree, apple, airplane, fish."

"Ball, tree, apple, airplane, fish."

The granddaughter, slightly annoyed, interrupted: "But, as I said, it's not really that kind of memory my mother is talking about, Dr. Chavez. It's things like forgetting to turn off the television, or what he ate for dinner."

"I don't want to hand control to Señor Serna, but I'm already giving it up to franchisees."

"When does this typically happen?"

"I think at all times of day, but I'm not sure. My mother knows, but she's traveling until tomorrow, and I was told you wouldn't be able to meet later this week."

"Well, your mother can always call me, but I honestly don't see any deterioration since your grandfather arrived. Señor Pico, you're in great shape."

Gloria glared at Dr. Chavez. Why on earth couldn't he have scheduled the visit later in the week? And why wasn't he offering to follow up with the daughter directly? One of Calidad de Vida's golden rules was to treat family members as clients, too. Gloria surmised that Dr. Chavez needed another round of training. His style was at odds with the Calidad de Vida methodology. She would call Jorge later that day to discuss this matter. She didn't doubt his commitment to high-quality, holistic care; Jorge had been a star pupil in the most recent training course at headquarters. But he clearly needed further coaching.

Angelic Temptations

Back at Calidad de Vida's corporate offices that afternoon, Gloria asked Daniel Hernandez, her CFO, and Diana Correa, her deputy director, to join her in the company's lone conference room, a windowless space made cheerful by photos of smiling elderly people on the

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walls and the same bright green chairs found in the centers.

"So you know I met with Victor Serna at lunch, and he wants to invest."

"That's great news," Daniel said.

"Well, yes, but there are strings attached." Gloria explained Serna's offer.

"Those are stiff terms, but if we want to pursue the aggressive growth strategy we've talked about, we could use that money," Daniel said. "I know we've had an easy time recruiting franchisees so far, but you never know what's going to happen. In this economic climate, we might get 10 new ones or we might not."

"I wouldn't worry about that," Diana countered. "Right now we have six candidates who look promising and, last time I counted, 35 information requests. We all know the demographics—an estimated 9 million people over 65 in Spain by 2020. And what about the possible master franchises in Portugal and Mexico? Ten won't be a problem."

"Sure, but we could easily have cash-flow problems along the road," Daniel responded. "All the franchises are hitting their performance targets, but we're benefiting only from the entry fees they pay us and from what we charge them for help with recruitment and training. It will take time before those percentage-of-sales royalties start to accrue. Even then, 5% isn't much, relative to what we could make from wholly owned centers. We're talking about 3 million euros."

"Let's talk about control," Gloria said. "I don't want to hand it to Señor Serna, but I'm already giving it up to franchisees. I was at one of our centers today, and a doctor there didn't even come close to following our methods. This business works only if the Calidad de Vida brand stands for high-quality, innovative care—across the board. How can we continue to do that, in as many centers as we ultimately want, without direct oversight? We've talked about consolidation, giving ourselves time to build and improve the business. Wouldn't this allow us to do both at the same time?"

"Perhaps," Diana acknowledged, "but it would take us a lot longer to get our own centers up and running, especially if Señor Serna meddles as much as everyone says he does. That would change the whole tenor of the organization. And would you really be ready in five years to sell the company or take it public?"

"Serna may have a reputation for meddling, but he's certainly a good businessman," Daniel said. "Why would an IPO be so bad? I wouldn't mind cashing in my equity at some point. And Serna's investment would generate publicity for our holistic approach to patient care."

"Do you think Serna might be willing to negotiate, Gloria?" Diana asked.

"It seems to be his terms or nothing. Look, we won't be able to decide this today. Let's all go home and think about it."

A FEW HOURS LATER, Gloria locked the office and looked down the street, where she could see the illuminated green logo of her flagship center. It was 7:30, so the last clients would be leaving for the night. She pulled a small card out of her purse, the same one that every Calidad de Vida employee carried. On it were listed operational rules and four core values: honesty (speak clearly but with respect), enthusiasm (those who don't believe don't belong), transparency (information is available to everyone), and a search for the common good (put yourself in the client's shoes). Could she uphold those values if she took Victor Serna's money?

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Should Gloria accept the angel investment?

See commentaries on the next page.

The Experts Respond

T. Forcht Dagi, MD, Queen's University Belfast, the Harvard–MIT Division of Health Sciences and Technology, and HLM Venture Partners

GLORIA HAS good reason to accept Victor's offer. She envisions 10 additional Calidad de Vida facilities over the next year in Spain and, eventually, abroad. Her company, however, is capital-constrained. She owns only one of 12 existing centers; the 11 franchised locations provide just 5% in royalties. Finding franchisees has been easy so far, but the franchising model may become less dependable in a dour economic climate. Fund-raising may be equally difficult.

Victor has offered €3 million for a 25% ownership stake and, thus, a post-investment valuation of €12 million. His terms outline typical protective provisions for a minority investor: a board seat, a vote on strategic decisions, and an option to obtain liquidity after five years. Although Gloria's stake would drop from 64% to 51%, she would retain majority ownership and, upon closing, the value of her holdings would increase by 11%, from €5.5 million to €6.1 million. Even if the margins were only slightly better than the royalty percentage, contribution to corporate from each facility would increase with a network of wholly owned centers.

Gloria's entrepreneurial ambitions are exciting. Nevertheless, establishing and growing 10 corporate-owned facilities within a year won't be easy. Gloria has no experience scaling at this pace and to this level. Each facility typically requires a year to break even. She needs to staff her facilities with trained individuals who subscribe to the company's values and innovative approach to elder care. In addition, she will need to intensify marketing efforts to scale recruitment and retention of clients, particularly during recessionary periods.

Gloria is building a brand on strict performance standards that demand intense engagement, high-touch holistic care, and customized service. The use of proprietary technology may help fulfill the brand promise and improve efficiencies of scale, but it cannot overcome requirements for adequate cash flow and financial discipline. Moreover, the need for additional investment during economic slowdowns cannot be dismissed, and capital reserves will matter even more if and when Gloria opts to build internationally.

Victor brings important intangibles to the table, including reputation and connections, which are highly valued in conservative European societies. Gloria may hesitate to change the board's composition, but Victor's broader business experience could prove very useful. A well-positioned investor, furthermore, can facilitate both access to additional capital and successful exits.

Victor Serna's offer is a heaven-sent opportunity.

Victor says that his terms are not negotiable, but they in fact establish only the four corners of the contract. For the sake of consistency with her principles and her mission—and as part of a due diligence process concerning an offer from an angel investor—Gloria should explore with Victor how closely their values, interests, and methods overlap. She may find less to fear than she imagines—and reasonable ways to resolve material differences.

Victor offers necessary, advantaged, and virtually effortless capital from a single, well-qualified source. This investment would allow Gloria to focus on running and expanding her business rather than on fund-raising. The offer is, quite simply, a heaven-sent opportunity.

WHAT WOULD YOU DO?
SOME ADVICE FROM THE HBR.ORG COMMUNITY

GLORIA HAS a growing, profitable business, and the market for it seems to be improving. She is in a great position, so if Victor is unwilling to negotiate, she should refuse his offer. He's not the type of person she'd enjoy working with.
Derek Pearson, *interactive director, Creative B'stro*

GLORIA'S BUSINESS model is about helping ordinary people—specifically, senior citizens. Companies like hers cannot be governed by committees, and that's what would happen if it accepted short-term investors such as Señor Serna.
Andrés López Josenge, *founder and principal, Direction*

GLORIA MUST decide whether Victor's objectives match hers. Franchisees can be encouraged to maintain standards through incentives or penalties. It's not as easy to control a wayward investor; if she and Victor clash, Gloria's dream could become a nightmare.
James Francis, *cofounder, Realliferunway.com*

GLORIA SHOULD accept the angel investment. She would still retain majority ownership, and having more owned locations would help solidify consistency in policies. But she must also retain her authority to decide whether the organization is privately sold or taken public.
Daniel Pierson, *student, Worcester Polytechnic Institute*

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Merle D. Griff, CEO, SarahCare Adult Day Care Centers and Home Care

VICTOR'S OFFER of €3 million is exciting news for Gloria. But as someone who is in the process of seeking investors to fund the expansion of my company, I would advise her to proceed cautiously.

Gloria will need to examine the business and legal implications of Victor's proposed deal, particularly with respect to the existing franchisee relationships. She must also evaluate whether the members of her staff have sufficient resources and an adequate infrastructure at their disposal to support expansion while still executing current operations effectively. Finally, Gloria will have to develop a strategic vision for collaboration between the wholly owned centers and the franchise locations, with the aim of meeting the company's long-term financial goals.

Entering into a business relationship in which red flags are apparent from the outset is never advisable. Victor's behavior toward Gloria at their lunch meeting reveals that he's accustomed to being a dominant force. His aggressive personality is not, on its own, a reason to discount him, but Gloria should make sure that her practical goals and her values align with Victor's before moving forward with him. Some key considerations include the timeline for opening the new centers, overall performance targets, and the consequences if those targets are not met.

Gloria should make sure that her practical goals align with Victor's.

Gloria and her chief financial officer may assume that Victor's value system matches their corporate philosophy because Victor is a physician. But he already seems to be disregarding one of Calidad de Vida's most important tenets—transparency—by refusing to negotiate the terms of his offer and by dictating a deadline without a clear rationale for it.

Other potential investors will share Gloria's vision.

It's not unreasonable to suspect, for example, that Victor would respond differently than Gloria did to the interaction between Dr. Chavez and Señor Pico's granddaughter at the flagship care center. Would Victor approve of Gloria's instinct to intervene between a doctor and his patient, or would he instead support his fellow physician by default?

This seemingly simple, straightforward proposal from an angel investor actually raises complex questions about the future direction of Gloria's company. Gloria should consult with her lawyers, board members, and management team—and then invite Victor in for another, more comprehensive discussion on her turf. The force of his personality might not be as strong in that context.

If Victor turns out to be unwilling to establish a process and a timeline that suit all the stakeholders at Calidad de Vida, Gloria should just walk away from the offer. Other potential investors will be more compatible with her personally and will share her vision. Without that type of bond, success will not be possible.

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