VENTURE CAPITAL 101

I. WHAT IS VENTURE CAPITAL?

Venture capital is money provided by an outside investor to finance a new, growing, or troubled business. The venture capitalist provides the funding knowing that there's a significant risk associated with the company's future profits and cash flow. Capital is invested in exchange for an equity stake in the business rather than given as a loan, and the investor hopes the investment will yield a better-than-average return.

Venture capital is an important source of funding for start-up and other companies that have a limited operating history and don't have access to capital markets. A venture capital firm (VC) typically looks for new and small businesses with a perceived long-term growth potential that will result in a large payout for investors.

A venture capitalist is not necessarily just one wealthy financier. Most VCs are limited partnerships that have a fund of pooled investment capital with which to invest in a number of companies. They vary in size from firms that manage just a few million dollars worth of investments to much larger VCs that may have billions of dollars invested in companies all over the world. VCs may be a small group of investors or an affiliate or subsidiary of a large commercial bank, investment bank, or insurance company that makes investments on behalf clients of the parent company or outside investors. In any case, the VC aims to use its business knowledge, experience and expertise to fund and nurture companies that will yield a substantial return on the VC's investment, generally within three to seven years.

Not all VC investments pay off. The failure rate can be quite high, and in fact, anywhere from 20 percent to 90 percent of portfolio companies may fail to return on the VC's investment. On the other hand, if a VC does well, a fund can offer returns of 300 to 1,000 percent.

In additional to a portion of the equity, a VC expects to have a say in how its portfolio company operates. Ideally, the VC fosters growth at the company through its involvement in managerial, strategic, and planning decisions. To do this, the VC relies on the expertise of its general partners who may be former CEOs, bankers, or experts in a particular industry. In most cases, one or more general partners of the VC take Board of Director positions at a portfolio company. They may also help recruit key executives to the portfolio company.

It's important to do your homework before approaching a VC for funding, to make sure you're targeting the right potential partner for your business needs. Not all VCs invest in 'start-ups.' While some may invest small amounts of "seed" capital for very early ventures, many focus on early or expansion funding (see section III. Types of Funding), while still others may invest at the end of the business cycle, specializing in buyouts, turnarounds, or recapitalizations.

VCs may be generalists that invest in a variety of industries and locations. More typically, they specialize in a particular industry. Make sure your company falls within the VC's target industry before you make your pitch – a VC that's focused on biotechnology start-ups will not consider your request for later-stage funding for expansion of your semiconductor firm. You can often gain insight into a VC's investment preferences by reviewing its website.

In addition to industry preferences, VCs also typically have a geographic preference. Being in the same general location as a portfolio company allows the VC to better assist with business operations such as marketing, personnel, and financing.

Keep in mind that venture capital is not an option for all new businesses. In fact, VCs are very selective in choosing new companies to invest in, so your company may not qualify. They're most interested in businesses with high growth potential that will allow them to successfully exit with a higher than average return in a time frame of roughly three to 10 years, depending on the type of investment. Given the rigorous expectations, most venture funding goes to companies in rapidly expanding industries such as technology, biotechnology, and life sciences.

There are some excellent alternatives to venture capital that you should also explore in your search for funding sources. One such alternative is an **angel investor** – a term for an investor that takes you under its wing and lifts you up to the next level of growth. Angel investors typically do not have deep pockets so the average investment tends to be smaller than that of a VC, typically hundreds of thousands of dollars rather than millions. For that amount of capital, proceed with caution if you're considering giving up some control over your company. For instance, it may not be wise to give a Board position to an angel investor who does not necessarily have the time, experience or expertise to make a significant contribution to your company.

You might also consider a **strategic investor** partner in place of a VC investment. This could be a vendor, customer, or other business partner with whom you're currently working, who might be interested in investing in your company. A strategic investor often has deeper pockets than an angel investor, but typically has a specific reason for investing in your company – make sure you know the reason behind the investment. The

investor may only want to leverage your technology for its own purposes, which could have a negative impact on your business. Or, the investor may want a licensing distribution agreement if your company succeeds, which could benefit you. Make sure your interests are aligned.

II. THE FUNDING PROCESS

Step 1: Business Plan Submission
The first step in approaching a VC is to submit a business plan. At minimum, your plan should include:

1. a description of the opportunity and market size;
2. resumes of your management team;
3. a review of the competitive landscape and solutions;
4. detailed financial projections; and
5. a capitalization table.

You should also include an executive summary of your business proposal along with the business plan.

Once the VC has received your plan, it will discuss your opportunity internally and decide whether or not to proceed. This part of the process can take up to three weeks, depending on the number of business plans under review at any given time.

Don't be passive about your submission. Follow up with the VC to check the status of your proposal and to find out if there's additional information you could be providing that might help the VC with its decision. If you are asked for further information, respond quickly and effectively. If possible, always try to get a face-to-face meeting with the VC.

Keep in mind that most VCs receive an average of 200 business plans each month. Of those, less than five percent will be invited to meet with the VC's partners. Just two percent will reach the due diligence phase, and less than one percent will be offered a term sheet. Some 0.3 percent of those submitting a business plan will ultimately obtain VC funding.

**The overwhelming majority of successful proposals come from a *trusted referral* of the VC, such as a limited partner, another VC, a known attorney or accountant, or other professional. *If you can get your business plan referred by such a contact, you dramatically increase your odds of succeeding in getting VC funding.*

Step 2: Introductory Conversation/Meeting
If your firm has the potential to fit with the VC's investment preferences, you will be contacted in order to discuss your business in more depth. If, after this phone conversation, a mutual fit is still seen, you'll be asked to visit with the VC for a one- to-two hour meeting to discuss the opportunity in more detail. After this meeting, the VC will determine whether or not to move forward to the due diligence stage of the process.

Step 3: Due Diligence
The due diligence phase will vary depending upon the nature of your business proposal. The process may last from three weeks to three months, and you should expect multiple phone calls, emails, management interviews, customer references, product and business strategy evaluations and other such exchanges of information during this time period.

Step 4: Term Sheets and Funding
If the due diligence phase is satisfactory, the VC will offer you a term sheet. This is a non-binding document that spells out the basic terms and conditions of the investment agreement. The term sheet is generally negotiable and must be agreed upon by all parties, after which you should expect a wait of roughly three to four weeks for completion of legal documents and legal due diligence before funds are made available.

III. TYPES OF FUNDING

The first professional investor to a deal at the start-up stage is referred to as the Series A investor. This investment is followed by middle and later stage funding – the Series B, C, and D rounds. The final rounds include mezzanine, late stage and pre-IPO funding. A VC may specialize in provide just one of these series of funding, or may offer funding for all stages of the business life cycle. It's important to know the preferences of the VC you're approaching, and to clearly articulate what type of funding you're seeking:

1. **Seed Capital**. If you're just starting out and have no product or organized company yet, you would be seeking seed capital. Few VCs fund at this stage and the amount invested would probably be small. Investment capital may be used to create a sample product, fund market research, or cover administrative set-up costs.
2. **Startup Capital.** At this stage, your company would have a sample product available with at least one principal working full-time. Funding at this stage is also rare. It tends to cover recruitment of other key management, additional market research, and finalizing of the product or service for introduction to the marketplace.

3. **Early Stage Capital**. Two to three years into your venture, you've gotten your company off the ground, a management team is in place, and sales are increasing. At this stage, VC funding could help you increase sales to the break-even point, improve your productivity, or increase your company's efficiency.

4. **Expansion Capital**. Your company is well established, and now you are looking to a VC to help take your business to the next level of growth. Funding at this stage may help you enter new markets or increase your marketing efforts. You should seek out VCs that specialize in later stage investing.

5. **Late Stage Capital**. At this stage, your company has achieved impressive sales and revenue and you have a second level of management in place. You may be looking for funds to increase capacity, ramp up marketing, or increase working capital.

   You may also be looking for a partner to help you find a merger or acquisition opportunity, or attract public financing through a stock offering. There are VCs that focus on this end of the business spectrum, specializing in initial public offerings (IPOs), buyouts, or recapitalizations. If you are planning an IPO, a VC may also assist with mezzanine or bridge financing – short-term financing that allows you to pay for the costs associated with going public.

A key factor for the VC will be risk versus return. The earlier a VC invests, the greater are the inherent risks and the longer is the time period until the VC's exit. It follows that the VC will expect a higher return for investing at this early stage, typically a 10 times multiple return in four to seven years. A later stage VC may be seeking a two to four times multiple return within two years.

IV. NON-DISCLOSURE AGREEMENTS (NDAs)

It's not advisable to ask a VC for a non-disclosure agreement, and may even risk stopping your potential VC deal in its tracks.

Venture capitalists may review hundreds or thousands of business plans in any given year. Even if you think your ideas are proprietary, they may be just similar enough to another entrepreneur's that the VC takes on the added risk of legal action against it just by signing your NDA. Also, for the VC, accepting NDAs adds the administrative burden of having to keep track of which NDA covers what entrepreneur's ideas.

Rather than focus on an NDA, do your homework to find a reputable VC that can be trusted with your information.

V. TERM SHEET

A term sheet is a document that sets out the basic terms and conditions under which the VC will invest in your company. Work completed in the due diligence phase of the funding process is used to draft this document. The term sheet is generally non-binding and is used as a template, along with further due diligence, to draw up more detailed legal documents.

You will, no doubt, be particularly concerned with the valuation of your company set forth in the term sheet. To arrive at this figure, the VC takes into account your management team, your company's market and competitive advantage in the marketplace, and your earning potential. The various factors that go into a valuation are determined during the due diligence phase. Note the difference between *pre-money valuation* – the valuation of your company before a VC invests in it, and *post-money valuation* – the pre-money valuation plus the contemplated investment amount.

A good tip for negotiating the best valuation is to have multiple VCs interested in investing in your company.

In negotiating your term sheet, keep in mind that there are two central issues for the VC. The first is the *economics* of the deal, i.e. the return on investment and the terms that dictate that return. The second is *control*, meaning how the VC will be able to exercise control over your company's decisions. The pertinent negotiations will revolve around these two issues.

VI. WHAT DO VCs LOOK FOR?

Venture capitalists look for businesses that have the potential to grow quickly to a significant size, yielding a significant return on the VC's investment in a relatively short period of time. VCs are not just interested in start-ups. Your company's current size is less important than its future aspirations and growth potential. A target company for a VC is one that may be capable of becoming a large market leader in its industry due to some new industry opportunity and competitive advantage. There's no single

determinant for a successful portfolio company, but a VC tends to focus on the following factors:

- *Commercially viable*. Does the company have a product or service that can be reproduced efficiently to generate revenue?

- *Identifiable market*. Is there a clearly defined market for the company's product or service? Does the company's product or service meet an identifiable need in that industry? Does the company have a reasonable plan to meet the identified need in an efficient, revenue-generating manner?
- *Strong management*. Does the company's leadership inspire confidence? Do they have the vision, expertise, and the ability to propel a business to a significant level of growth? Does the team consider best practices of those that have gone before them?

- *Sustainable competitive advantage*. Has the company hit upon an idea that's truly unique to the industry, one that has significant barriers to entry that will inhibit others from encroaching upon its market? Has the company considered economic and technological change that may affect the business model? Who are the company's potential competitors, and what are those companies' strengths and weaknesses?

Like a banker, a VC will also consider factors such as results of past operations, amount of funds needed and their intended use, future earnings projections and conditions. But unlike a banker, a VC is a part owner rather than a creditor, so it's looking for potential long-term capital, rather than interest income. A common rule of thumb is that a VC looks for a return of three to five times its investment in a five- to seven-year time period.

A lot may also depend on the relationship between you and the VC. Often, the firm will have you meet with every one of its individual partners to determine whether there's a consensus on how the company will be co-managed. Don't underestimate the value of mutual respect, teamwork, and understanding.

VII. VC EXIT STRATEGY

The exit strategy is the VC's way of cashing out on its investment in a portfolio company. A VC often hopes to sell its equity (stock, warrants, options, convertibles, etc.) in a portfolio company in three to seven years, ideally through an initial public offering (IPO)

of the company. The company becomes liquid through the sale of its stock to the public and the VC sells its stock to reap its return.

While an **IPO** may be the most visible and glamorous form of exit, it's not the most common. Most companies are sold through a **merger or acquisition** event before an IPO can occur. If the portfolio company is bought out or merges with another company, the VC receives stock or cash from the event.

Another alternative may be the reorganization of a portfolio company's debt and equity mixture, called a **recapitalization**. The VC exchanges its equity for cash, the management team gains equity incentives, and the company is positioned for future growth.

VIII. CONCLUSION

Before you approach a VC for funding, examine your goals. How much capital do you need? Do you want passive or active investors? Are you looking to ramp up your marketing efforts? Grow your management team? Does your Board of Directors need more seasoned expertise? Answering these questions for yourself will help you decide whom to approach for investment capital, whether that be a VC, angel investor, strategic investor, or other.

If you choose the VC path, make your best effort to get an entrée into your target VCs through a trusted referral. And always do your homework, both on the VCs you're targeting and on your own business needs. 'Do the math,' come to the table prepared, and keep your presentation brief and to the point. Know your ultimate business objectives, and be honest about those goals with your prospective investors.