Venture Capital Overview

Venture Capital is sought by many small and growing businesses, but only a very small percentage of those seeking venture capital are funded. For most it seems beyond reach. This article presents an overview of the VC funding process and is intended to help those unfamiliar with the process understand what's involved, who the process serves, and how to prepare for, approach, and manage it.

What is Venture Capital?

Venture capital is one of several common methods of privately financing a start-up or expanding business, and is most appropriate for high-risk enterprises with limited operating histories and big potential that require significant funding for large up-front expenses, rapid growth, or to accommodate large demand. VC is frequently used as interim funding to set the stage for a company's IPO or sale.

Venture capital is derived from either individual venture capitalists or venture capital funds, which are managed by venture capital firms. VC "Funds" are pools of money drawn from individuals, pension funds, investor funds, or corporations, established to invest in high-growth business opportunities.

VC Funds don't make large numbers of investments and usually limit them to particular industries, product types, or company circumstances, their "investment profile." A fund's profile determines its risks and return prospects, which are understood by and guide the fund's investors. Usually, the higher the risk profile, the higher the prospective return. By focusing on these particular investment types VC firms develop industry expertise, and are able to bring that expertise, financial experience, and significant industry contacts to the enterprise in addition to funding.

In the last 5 or 10 years, venture investing has shifted toward less risky later-stage investing, and away from early-stage, new-idea investing. Many companies with very interesting technologies are now routinely passed over by VC firms because they are too "early."

Based on established qualifying criteria (which vary depending on the VC source) VCs typically invest money (usually in the range of $1 – 10 million) in a high-growth company in exchange for an equity ownership position, with a clearly defined 3 - 5 year exit strategy. VCs usually require a reliable mechanism for, and enough control to govern, the conclusion of the investment at a stated point in the future. VCs look to create substantial value for themselves by deploying their funds to dramatically increase a company's stock price.

Because of these investments' risky nature, VCs spread their funds' risk over many individual investments. They know some will lose; and those losses have to be offset by the ones that win. This is why the VCs' return on any one deal has to be significant.

What is *Not* Venture Capital?

VC typically has strict requirements and criteria for its investment, which leaves most businesses to seek funding from alternative financing sources. Reliable capital sources to fund companies at lower levels to get them to the "next level" and ready for venture investment are not easy to find today. What is available includes family and friends, angel investors, enterprise development loans and grants, a practice called "bootstrapping," or bank loans.

Family and friends are those close to the entrepreneur, and commonly help with early stage start up financing (aka "seed funding"). These are appealing money sources because they are typically easier to persuade and less interested in ownership control.

Angel investors also invest primarily in early stage startups, are willing to invest their own capital in more speculative opportunities, and are often known to an entrepreneur or small company. Typical angel investors invest from $250,000.00 to $1 million, usually in exchange for equity ownership or convertible debt. Angel investors usually take a very high risk and require a high return, investing in young companies that don't qualify for other forms of financing like bank loans or venture capital.

Bootstrapping is essentially self-financing through use of the company's early phase profits. It can be a useful way for companies to demonstrate claims about a technology or market and establish credibility *before* approaching VC or angel investors.

While bank loans are often not available to entrepreneurs or small businesses, especially when the use of loan funds is speculative, those who can use loans to acquire capital assets that have a meaningful security or collateral value may find willing conventional lenders.

How to Choose and Approach a *Suitable* Venture Capital Funding Source

Many online resources and books devoted to the VC industry are available to help entrepreneurs identify VCs and better prepare themselves for approaching and pitching them. While finding suitable VCs is thus comparatively simple today, *properly* conducted searches can nonetheless take months or years. Even though many entrepreneurs believe that securing financing is about pounding the pavement and pitching as many investors as possible, they're wrong. Securing venture funding is really dependent on the *quality* of the investor contacts made, and the company's substance. Homework is critical.

Venture investors are barraged with investment opportunities, and they invest in a very small percentage of the opportunities examined – maybe 1 in 400. This is why companies seeking VC are well advised to start early and devote sufficient time to researching the VC industry, isolating specialists focusing on appropriate company or product types, and investigating a particular VC fund's investment criteria, its typical investment terms, how much and what type of control it requires, its principals, what types of investments it has made, its industry resources and connections, its limitations, and any intangibles that it brings to the table. Ideally, before pitching any venture investor, a company ought to be able to tell *that* investor how the company fits the investor's strategy.

Through this research process companies can identify who among the vast array of VC firms are *likely* to have interest in funding them, and why. By researching, companies can also learn whether they're ready for venture capital, or what they must do to *be* ready.

To improve prospects for success, companies must identify VC funds that are a good match. When seeking VC funding, a good match is a source that has strong interest in the company's industry, has the ability to invest the right amount of money to accomplish agreed (shared) objectives, and can advance the company's interests through industry knowledge, connections, and expertise.

When securing venture funding, companies are not only receiving money, they're entering into a long-term relationship (some liken it to a marriage). Companies are wise to look at compatibility issues and sources of potential conflict. When dealing with prospective venture investors, companies should evaluate:

- Can the management team manage (handle) a relationship with a venture investor?
- Do the venture investor and the company understand each other, and *really* agree on the fundamentals?
- Are the personalities compatible, and has a foundation of mutual trust and respect been established?

It's not worth taking money from an investor if doing so just sets the stage for managerial misery and disruption, communication breakdown, or shattered expectations.

What Makes a Company 'Ready' for Venture Funding?

It's a waste of time to pitch VCs if the company isn't ready and its owners haven't done their homework. Many seek venture funding because they think they *need* the money, rather than because they're *positioned and able* to use funds to grow effectively. There's a big difference.

To improve readiness, ask:

- Do we have a *proven* business model, or just exuberance, studies, a plan, and speculation?
- What is the state of our financial information? Is it supportable, thorough, accurate, and realistic?
- Can we withstand the scrutiny?
- Do we have the right management team in place, have we hired the best people we can find, and can they work very well together?
- Have we set the stage for success? Have we developed the right relationships or connections to gain an audience?

Like any business, just getting in the right door can depend on building relationships and the right introduction.

To be the "right" company for an investor, focus on fine tuning the business model and developing customers. Startups with paying customers can demonstrate their business model works, and are far more likely to secure venture investment. These companies are typically growing, have developed and adhere to a solid business plan, and are well situated to use venture funds to propel the organization to the next level.

Don't Expect to Pay Down Debt with Venture Funds

Before going to a venture investor, don't imagine the company will use investor funds to pay off old debt. While investor funds can be used to improve liquidity, investors want *their* funds to be used for growth, not paying down someone else's debt. Why? Because paying down debt doesn't generate any return for the investor or the company; it doesn't create value, it just reduces liability. Investors want their money to be used in ways that generate profit, to make *more* money with *their* money, not sink it into addressing someone else's old problems (which is how investors view a company's debt).

To be ready for funding, then, a company has to have handled its debt issues, and set the stage in a manner that enables the new funds to come in without being encumbered by or deployed to satisfy old obligations. Exclude any existing debt from any investment proposal.

Cut every expense not essential to generating a profit. When investors see a company wasting money on things that don't translate into profit or value, they're off to the next deal.

Being Ready – Focus on Building *Value*

While there are many things companies can do to prepare for the VC process, what's most important is *building value*. Some companies get too caught up in tailoring their business to meet the expectations of VCs or acquisition candidates; they make money raising itself their mission, and get distracted. When building real value is management's principal mission, the value itself attracts appropriate funding. So, instead of worrying about attracting funding, worry about building value, and the funding will be there, and the company will be much more likely to land it, … when it's ready.

Build value by meticulously planning, executing, and repeatedly refining and improving plans and processes, especially in the marketing and service areas.

What do Venture Investors Focus On?

Companies seeking VC must gain a clear understanding of what VCs are looking for and how they think. VC investment decisions revolve around "where is the risk?" When evaluating investment prospects, venture investors focus on two principal areas: likely return on investment, and risk management.

Important considerations include the:

- product being advanced;
- market(s) served, and market opportunities;
- regulatory path;
- data (evidence) suggesting the product is going to succeed;
- protection of the product / technology in the course of development;
- cost of getting the company to the point that revenue is flowing;
- timetable to revenue flow;
- proven business model; and
- valuation.

Generally, investors *don't* focus on the things entrepreneurs focus on. Entrepreneurs are usually focused on their technology and product, how impressed or happy the customers are, and how important or helpful the product is. Many entrepreneurs mistakenly think that their enthusiasm for their product will convince an investor that the product is great, and that if the investor recognizes how great the product is, they'll get excited too … and invest. This is not true.

Even if a business can save the planet, venture investors are fundamentally interested in one thing - making money. This means that presentations must promptly get to "return on investment," and the evidence supporting likely ROI.

Investors evaluate the *investment* opportunity and business *growth*, not so much the product itself. They're not concerned with "how great the product is" or that it's going to "transform the world," but with how and when its greatness translates into value: reliable sales, strong company growth, and market position. The product's potential is only one of many key factors considered by investors.

Venture investors look for strong evidence that the market is clearly and specifically identified, that the market segments served are rapidly growing, and that the company is, or can be, positioned to *dominate* that market growth, preferably through IP barriers to competitor entry, demonstrably superior technology, and superior management. A key is the competition – what they're presently doing, and what they're likely to be doing, to serve the market. Investors also evaluate whether the management team and its growth strategies are *capable* of supporting the proposed plan to dominate the market.

The management team is also critically important because without a talented, credentialed team execution will be hampered. But, there's always a shortage of great management teams, and building a rock-solid management team is typically a tough challenge. If management is somewhat less than optimal, it can usually be addressed, provided the other factors are solid (i.e., good people can be found). On the other hand, if the management is fabulous, but the product or market is not there, VCs' interest will diminish.

VCs' investment goal is to exit the company (converting their equity back to cash, usually through merger, acquisition, recapitalization, or a public offering) in five to seven years at a significant premium. They're always looking for a home run and for companies capable of growing *rapidly*, not over decades. Thus, all companies seeking VC are competing with all of those potential home runs.

The Role of Specialized Legal Counsel in Successfully Securing Venture Capital

For companies seeking VC, a management team's advisors, especially legal advisors, are very important. Lawyers experienced with the VC process and who understand the company's industry can be critical to preparing the company for the financing process, making wise decisions and negotiating successfully.

Legal counsel must understand the needs and concerns of VCs, recognize what VCs perceive as unacceptable circumstances, and manage the company's legal relationships *in advance* to avoid those concerns and meet those needs, while maximizing the prospects of successfully maneuvering the VC into the company and toward its exit. Counsel has to be capable of managing the company's legal affairs to maximize its ultimate value at exit, and avoid legal relationships that can scuttle exit strategies or limit profitability.

A company's intellectual property (IP) is *very* important to VCs. IP management and protection is often a key component of a company's growth and risk profiles, and in many cases it is fundamental to the product's viability in the marketplace, and the company's future. Legal counsel must establish a strong IP foundation in anticipation of rigorous VC scrutiny and due diligence.

Counsel ought to be able to help clients organize themselves for a VC's due diligence investigation. This is often done by preparing an IP and regulatory "audit" that identifies potential investors' issues and concerns, enabling the candidate to address the issues up front, and either resolve them or prepare a plan of action for doing so.

Issues of concern to VCs can't always be resolved or eliminated in advance, and VCs don't expect candidates to be trouble or issue free. But, demonstrating both the company's recognition of the issue(s) and its plan for handling them goes a long way toward eliminating a VC's *concern* about the issues. It also helps stop problems from growing, and demonstrates management's acumen, abilities, and potential.

Counsel for emerging companies who view themselves as VC candidates should organize these businesses in states with well-developed corporate legal systems, and they should keep the legal, organizational, and capitalization structures simple. Companies don't want to make themselves "organizationally difficult" candidates, because it just makes more work for everyone involved.

Proposal Presentation to Venture Investors

On any given day venture capitalists receive presentations and pitches from dozens of startups and entrepreneurs. Because VCs are skeptics, they're wary of exaggerated claims and overconfident talkers. For VCs to look at an opportunity, and be persuaded, the entrepreneur's presentation and its organization have to make the right impact. Hiring appropriate professionals to prepare the presentation materials is advisable, but it has to be the *company's* plan, not an outsider's.

Recognize the limitations on VCs' time, and be easy to understand and *concise*! Enable the VC to *quickly* appreciate the company's unique value proposition, understand its risks, and be *interested*. The documents to submit in advance of or during a face-to-face presentation include:

- Introductory Cover Letter
- Business Plan
- Executive Summary
- Power Point Presentation

These materials and the presentation must efficiently deliver the right information in the right manner, in the right quantity, at the right time. They should:

- Provide enough technology and other details to credibly illustrate uniqueness and value, without being complicated, or difficult to read.
- Identify the execution plan(s) for attaining stated projections, demonstrating their plausibility.
- Pointedly identify the business' relevant risks and present a realistic assessment of challenges.
- Be deliberate and honest about both the company's prospects and weaknesses. Explain how weaknesses can be overcome.
- Convince the VC that the opportunity is real, that the plan was actually conceived and produced by the management team, and can be executed by the party and team presenting it. (VCs readily detect cookie-cutter plans and won't take the company seriously if the materials presented are "consultant-made generics.")

Stage the company's presentation in a manner that encourages the VC to ask questions. Don't overload the VC with information. Anticipate and identify logical questions within the presentation, and be prepared to answer questions competently and quickly, ideally with supporting materials.

Establish a direct line of communication with the VC, rather than going through third parties (though third parties are often needed to get in the door). This directness provides the company and the VC opportunities to evaluate how the other conducts business, their professionalism, responsiveness, and commitment. Cultivating a solid relationship with the VC through a direct dialog enables the company to gain a thorough understanding of the VC's imperatives and processes. Regardless of whether an investment occurs, the relationship established and its honest discourse can be very valuable for the company.

Due Diligence

Venture firms typically conduct intensive business, legal, and IP due diligence on candidate companies before funding a venture. They thoroughly check all relevant facts, ask tough questions, and *verify* the answers. If a company, e.g., has a medical device that requires regulatory approval, that subject and the regulatory environment will be a critical due diligence focus.

Because of this rigorous examination, most companies suffer a series of rejections before "passing the test." It's part of the process. To get through this analysis successfully, entrepreneurs should be prepared to provide VCs with organized, well-researched, and authoritative supporting documents, market studies, customer indications, white papers, and industry research properly supporting their market and product or technology claims.

Foundational Agreements

VC investors look very carefully at what a candidate company owns. Common questions include:

- Does it own or control what it must in order to make money and later be in a position to either be sold or go public?
- Does it own the technology?
- Does it have rights to use a technology?
- Who else has these rights?
- Are there gaps in ownership?
- Do third parties have rights that may affect the future of the product or technology?
- Is the company properly protected in these matters?
- What agreements exist that may impose limitations on the company?

Every contractual arrangement affecting the company will be examined with an eye toward clearing the road ahead for sales growth and a successful exit strategy.

The Venture Capital Process

VCs are very serious about their investing; when they make a decision to invest, they're *involved*. They want to assure that the investment not only succeeds, but fulfills every bit of its potential. That's why they're in it. They'll do as much as possible, including managing it from inception to maturity and leveraging their experience and contacts, to support and guide the enterprise and ensure that they see a strong return on their investment. VCs are also often in a very good position to help a company recruit key management talent, or secure second- and third-round funding.

A VC's managerial involvement and the resources it brings can be a very positive attribute, but for many business owners, this oversight can be a negative. For many owners, especially for those who don't like outsiders telling them what to do, or who are not inclined to loosen their grip on the reigns, VC is not the right option.

Companies seeking VC must be willing to have a relationship with their VC source well beyond that of mere equity stake holder or investor; the VC relationship is frequently more like having a *partner* in strategically managing growth. It must be a strong, friendly relationship founded on mutual respect. Companies must therefore be keenly aware of each VC's particular approach to management. To the extent possible, the relationship between VC and the entrepreneur should be well-defined in the documents governing the investment.

Negotiations

Once a suitable and interested venture investor is found, negotiations begin. Negotiations may take a long time, they may be time consuming, and may ultimately lead nowhere. Dozens of negotiations with prospective VCs may need to occur before the right deal emerges and is actually funded.

Each negotiation is an opportunity to learn, adjust, and refine. To succeed, companies seeking venture funding need to be committed to this process for the long haul. Each VC a company negotiates with is a valuable resource that brings useful strategic, industry, or product information and perspective to the table. So, regardless of whether a particular VC actually invests, the company stands to benefit substantially from each interaction. This interactive learning experience is a process that ultimately aids in the company's preparation for the VC deal that works.

While everything is negotiable, subjects typically negotiated include the:

- amount of investment / funding required;
- equity ownership interest (usually 10 – 50 %, depending on pre and post funding valuations) for the VC's;
- dilution factors;
- type of securities offered (common or preferred stock);
- control mechanisms – terms of VCs active managerial involvement;
- industry knowledge, expertise, and connections to be provided by the VC; and
- company's stock valuation, pre-funding and post-funding.

Don't be afraid to negotiate; with appropriate respect for the VC, be prepared to stand up for the company, its knowledge, expertise, commitment and confidence. When entrepreneurs stand up for their companies, they gain respect and credibility. When they don't, VCs may take it as a negative.

When negotiating valuation, expect the VC's perception of company value to be different than the entrepreneur's. Early-stage valuation is an area that is subjective, and somewhat contentious, in large part because reliable valuation standards are largely absent. A common valuation method is the present value of future cash flows during a stated growth period (based on an investor's logical / reliable earnings assumptions).

Many factors affect valuation (including an investor's leverage), so be prepared to explain, justify, and document the company's valuation, and take advantage of its unique knowledge and expertise about the products, the market, and the industry. Be flexible and open minded concerning the VC's valuation opinions. An appropriate valuation based on the combined knowledge and experience of all parties will serve the company.

The Mechanics of an Investment Transaction – Documentation

Once a VC has evaluated an investment opportunity, and investment and valuation negotiations have commenced or concluded, refining and documenting the investment transaction occurs.

The parties (including counsel and consultants) will first determine what *type* of securities will be issued to the investors. Preferred stock, convertible preferred, participating preferred, common stock, stock options, convertible secured debt? Each has its disadvantages or advantages depending on the circumstances; so, the parties must give appropriate consideration to the tax, stock price change, dilution, dividend and liquidation preferences, protective rights, and transition and operational flexibility issues associated with each.

After determining the amount and type of investment, and the equity stake and its implementation, a "Term Sheet" is prepared. It identifies the basic terms under which the investment will occur, and states conditions to proceeding to close, including specific due diligence matters. The term sheet usually provides for confidentiality and exclusivity during the time required to prepare, refine or renegotiate document terms, and execute all appropriate closing transaction documents (commonly called the "lock-up period"). During the lock-up / document-finalization period the parties typically conduct high-scrutiny due diligence on pertinent fundamentals not earlier verified.

The principal documents usually required to close a venture transaction include:

- Amended and Restated Articles of Incorporation (AOI) – these are approved by the issuing entity's board and/or shareholders (as required under applicable law), filed with the secretary of state, and identify the class and terms of debt or equity issued to the investor(s) in sufficient detail to create a public record of the investor's rights and privileges.
- Stock Purchase Agreement (SPA) – Contains all transaction terms agreed upon by the parties governing the funding deal, including disclosures, representations and covenants, conditions, limitations on sale of securities, procedural requirements, etc.
- Investor Rights Agreement (IRA) – Identifies specific investors' rights not provided for in the AOI or SPA, and usually addresses the right to receive company financial information, registration of the securities with the SEC, rights of first refusal to purchase the company's securities in future financings, and rights to participate in stock sales by founders or employees. Rights with respect to dividends, preferences, redemption, conversion, and anti-dilution are set forth either in the IRA or the SPA.
- Company Counsel Opinion Letter – Counsel's written confirmation that counsel has reviewed certain aspects of the transaction and company records, especially regarding capital structure, IP and technology, assets owned, contractual rights, and the issuance of securities. It certifies certain information to the investor(s) based on that review. This letter is often itself the subject of serious negotiation because the investors want to rely on it, and counsel wants to minimize his or her exposure to liability.

Once all documents are finalized, the investment funding transaction closes (and money transfers) either on execution of all documents or at a different time as provided in the documents.

Conclusion

While successfully securing venture funding is tough, and a lot of work, the odds are *not* against companies seeking it. In fact, the odds are with those willing to take the time and devote the effort.