

VENTURE CAPITAL: WHEN A SMALL BUSINESS WANTS TO BECOME A BIG BUSINESS

By Marilyn J. Holt, CMC

Outside investors are tough, but getting the right venture capital is like talking a ride on a rocket.

When a successful small business wants to quickly become a big business, the most logical place to turn is to venture capital. Venture capital (VC) companies have a reputation for investing in young or start-up companies, but any company that can position itself for high-growth over the relatively short time of five years is a candidate for venture capital investment.

Venture capital companies come in all sizes, but there are basically two types of VC firms.

The first type is funded by high-net-worth individuals (angels) who have experience in quickly growing companies. Some of these individually backed funds are well-established companies that do deals year after year. Other individual funds are put together to do a few deals, perhaps in specific industry, then stay in business through the life of their investments.

The second type of VC firm raises its money from individual investors, pension funds, insurance companies, and mutual funds.

Some are part of large mutual fund families. Usually the people who put these funds together have experience in high-growth companies.

Both types of VC firms tend to invest in companies that are in industry areas that the principals know. A good VC firm knows where its strengths lie, and generally will avoid investing in an unknown area.

The amount of money under management can range from a low of \$3 million, which barely allows the fund any overhead costs, to several billion dollars. The huge funds are divided into several smaller funds. They tend to be well-staffed, and able to provide many of the services that a high-growth company needs.

No matter what the size of venture fund that invests in your company, those who have been through the experience agree that it is like being swallowed by a whale, or going from walking around the warm-

up ring to thundering down the back stretch on a thoroughbred race horse. Regardless of which analogy you apply, life after a VC is never the same.

WHAT A VC WANTS

In recent years, venture capitalists (VCs) have become more conservative in the type of company they want to invest in, but the basic end result is the same: they are looking for a higher risk investment that will give a high rate-of-return.

Typically, VCs want companies that can generate earnings that are five to ten times the amount of the investment over five years.

If you look at this as an annual rate of return on investment (ROI) of about 12.5% to 25%, compounded, the numbers do not look as daunting. Also remember that VCs want everyone to enjoy the same ROI.

Since few companies can provide this level of ROI over five years, and sustain this level of growth and earnings into the next stage of company maturity, VCs look very carefully at the business plans they receive, and the people who present them.

Historically, the failure rate of companies funded by VCs has far exceeded the success rate. Most of the information about the success/failure rate of companies funded by venture capital is anecdotal, but the VCs themselves admit that about ten percent of the companies funded met their expectations, approximately thirty percent

broke even, and the rest lost money. Some of the companies that lost money were liquidated or sold. Others were shut down. Few returned to the founders.

WHAT A VC LOOKS FOR

Above all else, VCs look at the quality of the management team, usually the founders. A VC is more likely to invest in an exceptionally good management team than an exceptionally good product, because an good, capable management team can overcome most difficulties all high-growth mode companies face.

A quality management team includes the best senior level people who are motivated to succeed. Since a successful high-growth business requires an excellent management team, when you approach a VC for investment, you should be prepared to answer the question: "Why are you the person (or team) who will make this succeed?"

The answer probably will determine if the VC looks any closer at your business.

Next, VCs look for indicators that denote a strong, lasting business. To be considered ready for venture capital, a company needs a viable product with sustainable proprietary features. The product should be aimed at identifiable customers in a large or growing market niche or segment. Preferably, the customers can be reached through existing channels. The market advantages of the product need to be supported by high gross margins.

VCs also look at a company's assets, both tangible and intangible. A solid asset base makes the company more attractive to VCs, and it gives the founders a stronger position from which to talk with potential investors.

The company also needs to be viable, that is continuously in business. A hiatus because of lack of funds or other problems likely will be viewed as a failed management team or product.

HOW TO APPROACH A VC

Raising money becomes more businesslike if you view it as another sale. Consider each venture capitalist as an individual customer.

You need to know what that particular customer's wants, concerns, and "hot-buttons." Doing this type of research on an investor is no different than researching customer preferences. When you approach a VC who you do not know, it is just like making a cold call. Just as you would not send your product to a customer unsolicited and expect to be paid, you should not send your business plan to a VC and expect to be funded.

The best way to meet VCs is through an introduction, an organized presentation or a letter. In the Puget Sound area, the Northwest Venture Group helps companies seeking funding meet venture capitalists and participate in organized presentations. The MIT/Forum also arranges organized presentations.

As with any cold call, writing to VCs either asking about the type of investments they

make or inquiring if they would like to see your business plan is effective.

When you write, include only a very abbreviated Executive Summary on your business. If they want to know more, they will ask for the business plan.

WHY HAVE A BUSINESS PLAN

The business plan should sell the company. When venture capitalists evaluate a potential investment, they expect to see a well-written business plan that reflects a deep understanding of the company, the marketplace, and the business community.

VCs want this business plan to be written by the founders, although professional help can be used. The ability to obtain funding is directly based on solid strategic planning. *How To Meet A VC*

When a VC invites you to discuss your business, be prepared to not only talk about your company in fine detail, but also how you will use the funds, how much solicitation of funding has cost your company, your past business practices, and all the various alternatives you have come up with to make your venture successful.

The VC will probably offer other view points and alternatives. You will need to decide how to respond. It can be like a test of how well you think on your feet. The VC will also try to take a measure of you as a person. You will be asked about your

family life, friends, interests, education, experiences, and lifestyle.

You need to take a measure of the VC, too. Learn how much authority the person with whom you are dealing holds. It is important to know if the person makes the decisions. If you receive funding, this person and the VC firm he or she represents will be your business partners. If you could not work with the VC firm, walk away.

The VC will also be looking for deal killers. Perhaps the most overriding deal killer is dishonesty. Always tell the bare-faced truth, even if it is ugly. VCs look for too much money (disproportionate to the value of the business) going to the founders and too little reinvestment in the company. They also look for "stupid CEO tricks," such as not paying the taxes, or not following jurisdictional regulations.

HOW TO NEGOTIATE VC FUNDING

Be prepared to do your own negotiating. Good negotiating practices are especially important. Before you enter into the negotiating phase, clarify in your own mind how much you are will to give up and how much you are willing to accept. Realistically assess your financing needs. Do not short change your business, or yourself. You and the other founders have to be able to live as well as you currently do. Also, do not promise more than you can deliver.

Be prepared to counter offer. Keep in mind the value of what you bring, as well as the

value of what they put on the table. As in any negotiating situation, seek a level plane and do not negotiate from weakness. When an offer is made, take time to examine and consider it. Remember that a deal that is good today will be good tomorrow.

After a tentative deal has been stuck, the VC will begin an investigative process called due diligence.

The VC will try to substantiate your claims from outside sources. The VC will contact your references, look at your management team, then scrutinize your products, markets, and claims. This process can last from six weeks to six months, or longer depending on the complexity of the company and products.

The VC will not only follow up your references and claims, but will look for anything that contradicts them. Depending upon what is found, the deal may go through, be modified, or die. The company accepting VC funding should conduct its own due diligence process on the VC. While most are legitimate, healthy, honest funds, some are not.

You too need to make sure that the VC is a worthy partner for you. Ask for references, check their credit, and see if there are any FTC, SEC, etc. complaints filed against them.

HOW TO LIVE WITH A VC

Expect life after venture capital funding to be exhilarating and challenging. The company will have a new partner, new expectations, new challenges. The most effective way to live with a VC is through constant communications. Keep the VC aware of both the good and the bad. Also use all the business experience that the VC has. VCs are often active in the company. Insist that your VC helps you make the company as successful that they expect.

HOW TO LEAVE A VC

One of the greatest challenges in living with the VC will be preparing for the venture capital end-game. About five years after investing in your company, the VC will have to divest it. While that you are pushing the company through phenomenal high-growth, you will be positioning it for a management buyout (MBO), partial sale, outright sale, or an initial public offering (IPO). Once this is done, you may become an angel or a venture capitalist, or start the process all over again.

AFTERWORD

The article was written a long time ago, yet it is as relevant today as it was then. May things have changed, yet many things have remained the same. The article has been updated over the years.

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