catalyst venture partners

Developing and funding great companies

Raising Venture Capital

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Introduction

This paper is designed to help technology understand the process of raising venture capital funding. It is intended to be a practical guide. We focus on the nature of venture capital and the stages of the investment process.

The Nature of Venture Capital

What is venture capital? Venture capital is the provision of finance to unquoted companies. The investor effectively becomes a partner in the business. This varies from friends and family putting in £50,000 to a multi-million pound buyout deal.

What's in it for the venture capital provider? It seems to come as a shock to many people that the venture capitalist is in it to make money and lots of money. Most funds have a target return of 35% per annum. This though is from a portfolio, which contains companies with widely different levels of performance. Overall the performance of investee companies tends towards the third, third, third rule: a third of all companies invested in either stand still or fail; a third are moderate successes growing at between 10-20% per annum; a third are extremely successful with growth rates in excess of 100% per annum. To ensure that the fund meets its overall return most VC's therefore look for returns on investment in excess of 50% per annum and frequently over 100%.

Stages of Investment. All sources of venture capital have their "sweet spot" both in terms of sector and stages of the development of a company thus it is important to appreciate what stage you are at:

> **Seed corn.** This is the development of an idea into the foundation of a start-up. A typical example is the inventor in his garage obtaining funding to create an early proto-type of a knowledge management software product.
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> **Start-up**. This is a company that may or may not be ready to start trading but has a clear business proposition and well defined markets i.e. developing a working prototype into a product that can be sold. It typically has a core management team and a well-defined market strategy e.g. sell our knowledge management product to consulting businesses.
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> **Early Stage**. This is a business that is making sales but has yet to make a profit. This business will have ironed out many of the teething problems: recruited a sales force; produced a second version of the product; have some reference clients; have a grounded business plan that is achievable.

Expansion. This absorbs over 50% of all venture capital funding and is used to grow an established business providing funding for: additional working capital; funding for a new product or service; moving into new geographical markets; capital expenditure.

Other uses of venture capital are: acquisition; debt replacement; management buyouts; buyins; rescue capital, and replacement capital. These need not concern us as this paper is focussed at early stage technology businesses.

The Investment Process

Venture capital companies receive hundreds if not thousands of proposals each year. Of these most VC's invest in between 5 and ten companies a year. Few make more investments than this. 3i might do thirty deals a year in the UK but that is an exception. Most Venture Capital businesses are run with a handful of investment executives who will have a wide range of responsibilities from doing deals to monitoring performance to managing an exit. Key people are very busy and thus to get noticed you need the right approach guided by the right people.

Broadly speaking there are 8 stages to the investment process:

Stage 1. Initial Review – The Executive Summary

"Read over a cup of coffee when distracted by a dozen other issues…"

If a VC is receiving 5 proposals a day (1500 a year) then - unless it's from a trusted source - each proposal will get very scant attention. The executive summary is read to see if the project fits the sweet spot of the investor:

- **Investment stage** – Many VC's will only consider businesses once they have achieved breakeven, others will only consider very early stage.
- **Sector/market** – Technology investment requires market knowledge. Many VC's have developed an understanding of a particular group of sectors such as 'Wireless applications' or 'biotechnology' and are loathe to stray out side of these areas.
- **Size of company** – Some will only invest in a business which has a valuation of £25 million or more, others are focussed on businesses with a valuation greater than £50 million.
- **Size of investment** - Some VC's are seeking to invest a minimum of £5 or £20 million in a particular company others have targets of £1-2million.
- **Intellectual property rights** - Attitudes vary within the VC community on IPR – for some it is a plus for others it is a necessity.
- **Quality management with sectoral expertise** - This is probably the most important factor upon which everyone can agree – inadequate management behind a project and no deal.

Most projects fail at this stage. Many because they deserve to, but many because they are not presented properly by the right person.

Stage 2. Review of Business Plan

"Skimmed at rapid speed…"

If the executive summary looks good then the business plan gets read and evaluated. The key issue here is does the story look credible? This is not seeking to assess whether it will work or not but does it look plausible with the right sort of management team behind it.

If it looks good then the next stage is meeting the management team.

Stage 3. Meet the Management Team

"15 minutes early and you have halved the preparation time…"

Do not overestimate the importance of this step but neither assume that because the VC wants to see the management team they want to go ahead. This is simply another hurdle. If there is any doubt that the management team are not up to the job then this is where it all goes wrong. Do not assume that the VC has read or understood anything. At this stage you have to sell the project and the team behind it. Your objective is to make the VC leave the room believing that he has found a winner then you have found your champion within the organisation.

Stage 4. Internal Discussion and Initial Verification.

"So what do we reckon guys – nah its an ebusiness project…"

Having believed that he has found a star your champion will then engage in some general research to make sure he is not being sold a pup. He will ring up some of your customers, make sure the market is large enough, take a look at some of your competitors. When he is confident that he should be taking you and the company seriously he will then put it forward as a project for consideration. Most VCs' have a policy that the majority, or in some cases all, of the investment directors must agree on whether to pursue an investment opportunity.

This means that whether you succeed or not can depend upon the persuasiveness of your champion to convince his partners that this worth while taking to the next stage. The importance of this stage is that this is where money or resources are committed to carry out a detailed assessment. The first stage of this process is usually, but not always, the issuing of a term sheet.

Stage 5. Term Sheet

"This is what our money will cost you…"

Having decided that they are interested they will make you an offer. This offer will be a wish list – negotiate hard. It will also be subject to due diligence i.e. a detailed investigation into your business. The terms of the money on offer only gets worse once the due diligence process is underway – either because the project really is worse than appears or because its suits the investor, rather like a house buyer, to make the due diligence appear worse. You need advice at this stage from a lawyer or a

corporate financier who has seen many of these to assess what is reasonable and what is not.

Stage 6. The Due Dilligence Process

"Your dirty linen will be washed in public – so don't kid yourself…"

For many companies the worst part of the investment process is the analysis of the business. This may involve:

- external consultants to evaluate your technology;
- detailed discussions with your customers;
- a management review by HR consultants;
- a detailed assessment of the business by a firm of accountants.

Most businesses have dirty linen stashed somewhere or other – a contract which is not entirely legitimate, a sale and leaseback agreement which was done when the business was in crises. Before engaging in the investment process wash your own dirty linen. Make sure that you go into the investment process squeaky clean otherwise you will waste everyones time.

Stage 7. The Legals

"There are sharks in the water…"

The point of the legal process is to write down in clear and unambiguous language what each party is expecting from the deal. This can produce and usually does a whole raft of issues which have not been agreed or were thought to have been agreed but - when it comes down to agreeing a specific wording - there are differences of view. The legal process provides value in two ways: firstly, it clarifies all parties understanding of the deal to be done. Secondly, it provides a 'bible' of rights and expectations when things start to go wrong.

Good legal advice is essential at this stage of the proceedings – get the best you can afford. Do not be deluded by the reputation of a firm go for the individual you know and trust.

Stage 8. The Completion

"The deals not done till the money is in the bank…"

After extensive discussions the final part of the process is the inking of the deal. This will involve signing lots of bits of paper which you should by now be perfectly happy with. However, inevitably there are a few remaining issues which cannot be resolved until the stakes are so high that sense prevails. The key to this stage is keeping your cool.

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