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Smarter ventures

A survivor's guide to venture capital through the new cycle

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Jargon buster

Below is a guide to some of the jargon that infests the world of venture capital. It is by no means comprehensive; for instance, if you are struggling over one of the many prolix terms lurking in an investment agreement, turn to Chapter 13. Nor, for obvious reasons, does it attempt to explain basic business terminology, such as ordinary and preference shares.

angels *See* business angels.

anti-dilution rights A mechanism by which investors try to protect their position if subsequent rounds of financing occur at a lower valuation. Beware – these can be a source of much acrimony in future funding negotiations (see Chapter 13: 207).

bridge financing A loan typically extended by existing investors to tide a company over until it secures further finance. The trick is to make sure it is a bridge, and not a pier – in other words, that the facility does not expire before the new money is in place. The terms are likely to include an equity kicker, allowing the investors to subscribe to any new round at a discount. As always, the more you need the money, the harsher the terms are likely to be.

business angels Wealthy individuals who supply cash – and often, entrepreneurial and business skills – in return for a stake in an early stage company. They are to be distinguished, in terms of their net worth and, with any luck, business acumen, from the alternative source of very early stage funding, namely the three Fs – friends, family and fools. The wider catch-all term private investors is probably more appropriate – these people are not in it for philanthropy, after all – but the angel moniker seems to stick.

buy-out Often called management buy-outs in the UK and much of the rest of Europe, leveraged buy-outs in the USA. The purchase of a mature, generally profitable, business, by a **private equity** firm, which

then owns the company for a period of three to seven years before exiting it via a **trade sale** or an **initial public offering (IPO)**. These businesses are private, often orphan divisions of large companies, family businesses, or sometimes, listed businesses taken private. Drivers of returns include leverage. Substantial levels of debt will have been injected at the beginning. The management team will also be motivated to do a good job by being given an equity stake. This exercise, which dominates private equity activity in Europe in terms of scale, has historically also been referred to as venture capital, which is clearly nonsense.

captive A venture firm owned by a financial institution – a bank or insurance company. This has been particularly prevalent in continental Europe, although these teams are today increasingly seeking independence. Captives invest entirely using the balance sheet of their parent; **semi-captives** raise some **third party funds** from other institutional investors, to supplement balance sheet funds. This is often as a prelude to going fully independent. Captives can be rather bureaucratic and impersonal in their ways. Just try finding anything about the backgrounds of team members, or even their names, on the website.

carried interest/carry The locus of the jam – if you are a venture capitalist, that is. In the typical **limited partnership**, profits are divided so that 80 per cent go to the **limited partners** (institutional investors) and 20 per cent to the **general partner**. Carry has made a lot of venture capitalists very rich indeed. Its distribution within any individual partnership – according to carry points, typically allocated at the beginning of each new fund – can be the source of great angst, instability and ultimately, if it is felt to be really inequitable, the break-up of some firms.

cash multiple One measure of a venture capitalist's return. A $200m fund which eventually produces proceeds of $600m to investors who committed the original cash is said to have achieved a three times multiple. Or, at the level of an individual investment, $2m turned into $20m is a ten times multiple, sometimes known as a 10x. It is a very different measure of return from an **internal rate of return (IRR)** and an institutional investor assessing a venture firm's performance would look at both.

claw backs When it all goes wrong in the **carry** milch cow department. During the bubble VCs would take their share of the carry on individual investments, only to find that, following the crash, the fund as a whole was **under water** and the sums taken in carry were in fact owed to investors just to repay their initial capital (or the capital plus the **preferred return**). If the cash has been sunk into other technology stocks in the 90 per cent club, or time shares in private jets, this can be more than a little uncomfortable for the VCs. (This has been a much bigger problem in the USA than Europe.)

corporate venturer A corporation that takes minority stakes in other companies, which can take many forms. The most relevant for young companies in search of cash are corporate VCs with an in-house fund that invests in businesses external to the company (by contrast with those that incubate internally generated ideas). Unfortunately, corporates are some of the most fickle investors around, and disappear almost entirely in down cycles.

cram-down A particularly punitive form of **down round** where founders and existing investors find their shareholdings 'crammed down' to next to nothing by the demands of the new investors in a current funding round, who have the whip hand if the company is to survive.

down round A financing round where the valuation is lower than the previous rounds. Companies that raised initial funding in the bubble suddenly found that investors would put up further cash only if the valuation was greatly reduced. Drastic down rounds unfortunately leave founders, angels and existing shareholders with equity worth very little indeed.

due diligence A fancy word for research. If a venture capitalist is sufficiently interested in an investment proposition, he will perform due diligence, looking into everything from the backgrounds of the team to the solidity of the patents of a technology business. In bubble periods, this process is concertinaed down to a minimum. In a downturn, the procedure appears to drag on indefinitely, and can indeed sometimes serve as a handy cover for investor dithers.

elevator pitch A well-prepared elevator pitch is a necessary piece of an entrepreneur's armoury. A US concept, it refers to a chance encounter between entrepreneur and investor in an elevator; the former must enthuse the latter about his proposition before the doors roll open again a few floors on.

exit VCs only make **returns** as and when they exit, or realize, their investment. The most likely form of exit is a trade sale or, when market conditions are right, an **initial public offering (IPO)**. The latter tend to generate the really big wins – although, even if they actually happen, founders and investors will not be able to sell immediately, not least because of **lock-ups**.

first-time fund For VCs, as for entrepreneurs, there is always a first time. However, the suppliers of cash to the venture industry, the institutional investors, are notoriously reluctant to commit capital to teams who do not have a track record, which makes it hard to get started – except in a bubble, when people will put money behind an elephant with hay fever.

flotation *See* **initial public offering (IPO)**.

fund This is the investment vehicle of a venture capitalist. The salient points about it are its size (€100m); vintage (2001) and its number (Fund 3, namely the firm's third fund); generally organized as a **limited partnership**.

general partner (GP) In a limited partnership structure, the venture capitalists are general partners, or else own the company which is itself the general partner. By contrast with the **limited partners**, the general partner can be liable for a fund's debts – hence the attractions of forming a company in which the VCs are shareholders.

hurdle rate *See* **preferred return**.

initial public offering (IPO) An initial public offering is the means by which a business obtains a listing on a stock exchange, or 'goes public', enabling it to sell shares to the wider investing population. Something of a rite of passage for an entrepreneur, but only a few companies actually achieve it, and the IPO 'window' can remain closed for years at a time, when the bears hold sway and investors are simply averse to the idea of new offerings.

internal rate of return (IRR) A discount rate – the rate at which all the fund's cash flows (commitments by investors and disbursements back to them) are discounted so that the net present value of the fund amounts to zero. Together with the **cash multiple**, these are the two principal benchmarks of a venture capitalist's performance.

institutional investor As opposed to a private investor. These are pension funds, insurance companies, endowments, foundations, who are the primary source of capital for the venture industry. They do not by and large have the resources or expertise to invest directly in companies, so they invest via VCs' **limited partnerships**.

IPO *See* **initial public offering.**

IRR *See* **internal rate of return.**

limited liability partnership/limited partnership This structure, governed by a partnership agreement, is how US venture firms have been organized since the 1960s and 1970s. Many European VCs have also adopted this form. The limited partnership has a finite life, generally ten years. The idea is the VC invests the cash in the first three or four years (much more quickly in the late 1990s) and then harvests the proceeds in the remaining life of the partnership, which is then wound up (sometimes after an extension).

limited partner Institutional investors in a limited partnership. The LPs, as they are often known, are 'limited' in the sense of only being at risk for the amount of their investment – by contrast with the **general partner**.

liquidation preferences Another bombshell that may be buried in the investment agreement. This is a provision whereby the last round of investors get their money out before everyone else – and multiple liquidation preferences, where they are due a multiple of their investment sum, can wipe out founders and early investors in the event of even a fairly successful exit. Liquidation, by the way, refers not primarily to the winding up of a failed company but to any 'liquidity event' that generates investment proceeds, such as a trade sale (see Chapter 13).

lock-up A provision stopping founders, angels, VCs and others from taking their shares and selling at the first opportunity following an **IPO**. Lock-ups for founders typically last six months or longer. Their duration can be the subject of fierce negotiations with the investment bank underwriting the offering.

management fees VCs are paid a fee on the funds under management. The clever thing about this, from the VC's point of view, is that institutional investors pay a percentage of the sum *committed*, rather than, say, the sum invested, which at the beginning would be a tiny amount. The fees are supposed to cover expenses and so on, but the bigger the fund, the more is left over to pay high salaries and bonuses.

mezzanine round A pre-IPO financing round. A confusing term since mezzanine, in a buy-out, means a layer in the capital structure somewhere between equity and debt. In venture capital, a mezzanine round is an equity round like all the others.

multistage A multistage VC firm will invest in both young companies and leveraged buy-outs (LBOs) – and maybe everything in between. This is a phenomenon that is more common in Europe than the USA, and is arguably a function of the more institutional approach to venture capital and private equity in Europe. Detractors would say that the skills required to invest at these very different stages of a company's life are quite distinct, and that VCs and LBO specialists do not belong under the same roof. The large funds that multistage firms raise soon mitigate against real venturing because it is not cost effective to make small investments.

non-disclosure agreement (NDA) Something which almost all VCs have an aversion to signing.

post-money See **pre-money**.

PPM See **private placement memorandum**.

pre-money A pre-money valuation is the value of the business ascribed by the venture capitalists *before* the investment has been made. Hence an injection of €2m 'at €2m pre'. This gives a **post-money** valuation of €4m and the VCs a 50 per cent share of the equity.

preferred return A hurdle rate, generally about 8 per cent, which a VC has to beat before he starts to earn carry. So, for a €100m fund with an 8 per cent preferred return, he would need to return €108m to investors before carry was due.

private equity In its broadest sense, the provision of equity finance to unquoted companies. The terminology is a minefield. In the USA, private equity denotes the leveraged buy-out part of the business, as distinct from venture capital. Private equity can also, confusingly, be used as an umbrella term to refer to everything from venture to leveraged buy-outs (LBOs). American usage is becoming more common in Europe, although, historically, venture capital has been the catch-all term for private equity activity, including management buy-outs (MBOs).

private placement memorandum (PPM) The marketing document issued by venture capitalists when they go fund raising. In the highly secretive world of VC, this is the nearest you will get to lifting the veil on a venture firm's performance numbers. Although the material is of course carefully doctored, a PPM can give a useful indication of the health of a venture firm's portfolio. These documents are not easy to get hold of either, but there is something of an underground 'trade' through intermediaries, including lawyers and, once you have one, you have currency.

returns The cash generated by venture capitalists courtesy of their investors' money. Negative returns are what happen when VCs lose money. You may also hear VCs talk about realized and unrealized returns. Realized returns constitute real cash back to investors. Unrealized returns are estimates of the value of companies that remain in the portfolio and, given the unquoted and early stage nature of the businesses, a highly subjective matter.

seed The hardest form of capital to secure – €100,000 or so, or less, to develop a prototype product and the business plan. Venture funds have become ever larger in recent years – not least because that is how they make money personally – with a deleterious effect on the provision of capital to this utterly essential part of the venture ecosystem.

semi-captive *See* **captive.**

serial entrepreneur A company founder who has done it before – built and probably exited a previous business. A breed much beloved of venture capitalists, because they feel they are taking fewer risks with individuals who have been through the mill before.

series A (and subsequent letters of the alphabet) Series A is first round funding (after seed). The traditional US model saw two or three rounds of funding (say to series C) with new investors coming in at each round, paying steadily increasing valuations before the business is sold. During the bubble, when public markets were highly receptive to IPOs, companies would sometimes list with just series A funding. As the bubble unwound, financing rounds were done at steadily lower valuations – **down rounds** – and attracting new investors became difficult. Now VCs are increasingly syndicating investments at the outset so that they are not reliant on outside investors further down the road. This is more akin to the old European model, where a single investor would often fund a company to exit.

syndication The sharing of a deal by more than one venture capitalist. As well as providing extra pools of cash, VC syndicates can supply complementary sector or geographical expertise, a wider hinterland of contacts and so on.

term sheet The prenuptial agreement between entrepreneur and venture capitalist, containing the terms which will later appear in the investment agreement. Pivotal in the negotiation of any investment.

third party funds Money from outside institutional investors. For example, **semi-captive** venture firms invest partly off the parent's balance sheet, and partly with funds raised from other third party institutional investors.

trade sale The most common kind of exit; the sale of the business to another, often much larger company, for cash, cash and shares, or shares.

under water A fund is generally said to be under water when it appears it will not return investors' original capital in full. VCs do not survive long if they lose investors' cash.

VCT *See* **venture capital trust.**

venture capital The provision of equity capital to private young companies. For terminology confusion, *see* **private equity.**

venture capital trust (VCT) A UK-listed entity which offers tax breaks to retail investors. Designed to encourage start-ups, rather too much cash found its way into small management buy-outs. Some VCTs do still fund venture businesses, but if you are considering them as potential backers, beware that quality is very mixed.

washout *See* **cram-down.**

X As in 5x or 10x. *See* **cash multiple.**