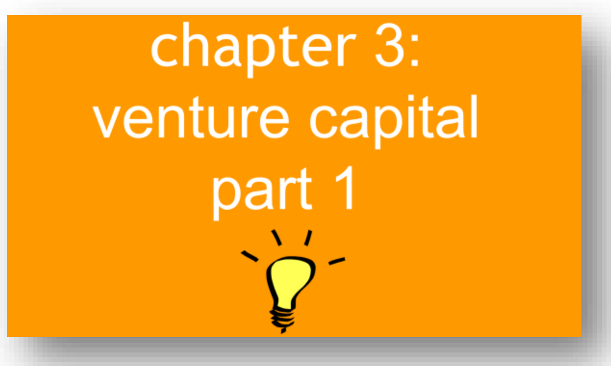
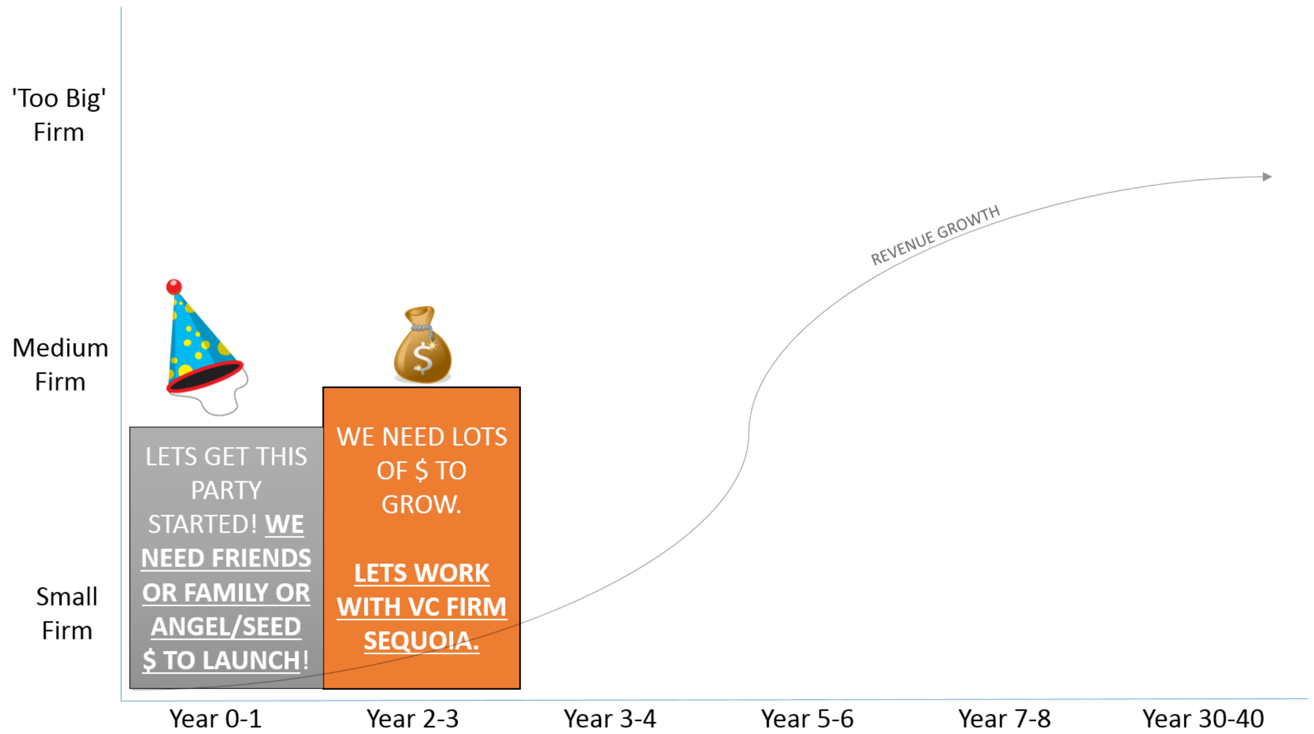
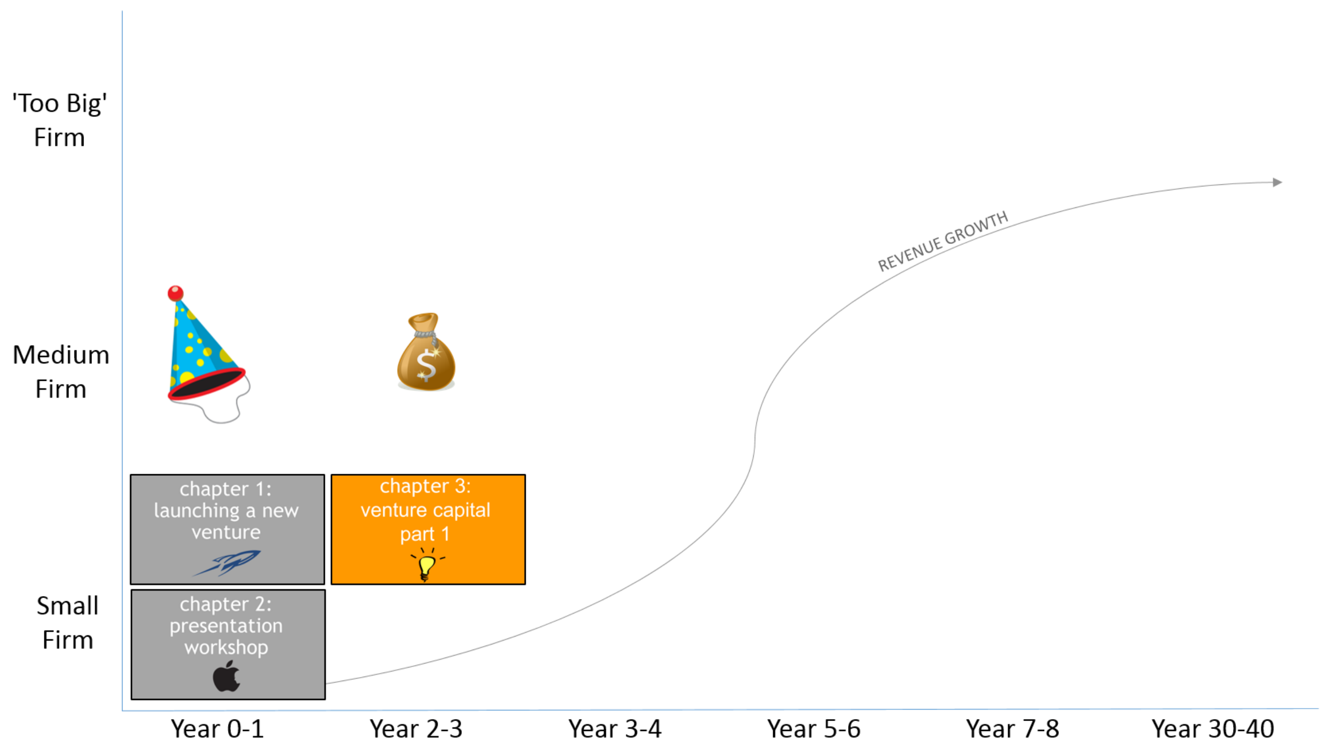
CHAPTER 3: VENTURE CAPITAL PART 1

"Ideas are commodities. Execution is not."

- *Michael Dell*




'Too Big' Firm
Medium Firm
Small Firm
REVENUE GROWTH
LETS GET THIS PARTY STARTED! WE NEED FRIENDS OR FAMILY OR ANGEL/SEED $ TO LAUNCH!
WE NEED LOTS OF $ TO GROW.
LETS WORK WITH VC FIRM SEQUOIA.
Year 0-1
Year 2-3
Year 3-4
Year 5-6
Year 7-8
Year 30-40


'Too Big' Firm
Medium Firm
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REVENUE GROWTH
chapter 1: launching a new venture
chapter 2: presentation workshop
chapter 3: venture capital part 1
Year 0-1
Year 2-3
Year 3-4
Year 5-6
Year 7-8
Year 30-40

Why do we spend so much time on venture capital in this book? The reason is that you always want to use other people's money when starting a company (unless you are loaded). I don't want you to put your family at risk by over leveraging yourself. I don't want you to ever get bank loans either as banks will panic and make you pay back every penny if you are late on just one loan payment (and maybe come after your house…always put your family first)! Instead, I want you to sell part of your company (unless you are loaded) to an equity investor, including high net worths, companies or venture capital firms. It is so incredibly hard to get funded by a top venture capital firm. If a top venture capital firm funds you, then your chances of being successful rises materially. As such, we need to understand what these top venture capital firms look for in a company they are considering investing in! We also need to understand the fascinating history of the venture industry too (which we will do in another chapter…observe how the greatest entrepreneurs did it).

THE MOST IMPORTANT INVESTMENT CHARACTERISTIC IS….

Venture capital firms focus primarily on having a superb management team unlike this dude presenting to a potential investor and also to venture capitalists. Pay **very** close attention to what not to do in this video:

www.tiny.cc/chris36

:)

There is nothing more important with an investment that finding the right management team. The jockey is always more important than the horse.

Ideas are commodities. Execution is not. The most important critical success factor in business is investing in the right management team and not investing in the right idea. Why is it that most business schools don't dedicate any time to assessing the quality of a company's management team? Shouldn't this be the most important thing to consider before making an investment in a company? We spend far too much time analyzing business models, markets and financial statements and we often overlook the most important investment quality, which is who is running the company and are they the right choice?

This is especially true in the money management or venture capital industry where the most important success factor in any investment is making sure that you have the right management team in place. The right management team can pivot, adapt and react to a material crisis or constantly changing end markets. The right management team can effectively market elegant products to their customers with the simplicity of Apple's Steve Jobs and with the healthy paranoia of Intel's Andy Grove.

Past performance is indicative of future performance if you have the right CEO and the right management team. Yes that was a very controversial statement, but I believe that if you bet on a management team that has been extraordinarily successful in the past, then your chance of success betting on this management team in the future is materially higher than it is betting on a B or a C management team.

The best CEOs and entrepreneurs don't have a job; they have a passion. Superb examples of passionate CEOs and entrepreneurs include Richard Branson of Virgin, Marc Benioff of Salesforce, Christian Chabot of Tableau and Godfrey Sullivan of Splunk. The best CEOs and businesspeople in the world are passionate salespeople with unbelievably positive attitudes. Their positive attitudes lead to an incredibly positive corporate culture. Fly on Virgin America or Virgin Atlantic and you will understand why Virgin is an exceptional brand. Virgin employees are so happy that they don't appear to have a job! Rather, they have a passion. Watch an interview with Richard Branson and you will understand why.

Similarly, employees of technology company Splunk are incredibly positive people and this might be due, in part, to the incredible leadership of their CEO Godfrey Sullivan whose genius is that he praises often in public and only offers constructive feedback in private. The result is a relentless, positive 'can-do' attitude that resonates throughout the entire company. This has led to the creation of one of the best corporate cultures in the history of the technology sector.

How do we assess if a CEO or an entrepreneur is worth backing? We can use www.Glassdoor.com and read reviews of the management team written by employees. Godfrey Sullivan from Splunk and Marc Benioff from Salesforce both have 96% approval ratings according to Glassdoor.com from employees and Christian Chabot from Tableau has a 100% approval rating!

How do we do additional background checks on a CEO before deciding to invest in the company? Never call references that the CEO provides as nobody would ever provide a reference list of people that wouldn't say something positive! Rather, use LinkedIn and find contacts that you (or your friends/colleagues) have that know the CEO or people that work at the CEO's company. Then simply call these contacts and ask for feedback on whether or not the CEO is an effective salesperson and leader.

For private companies, read about the background of the management team on the company's website. For publically traded companies, you can read the annual reports, which all have descriptions of the background experience of the executive team. You can find a wealth of information online at www.sec.gov .

The productivity of employees of a company with a passionate, visionary leader is materially higher than the competition. More productive employees leads to enhanced shareholder value over time. We will all be much better investors if we spent a lot more time analyzing management teams. Only after we feel comfortable backing the right management teams should we start doing due diligence on the business model or the total addressable market.

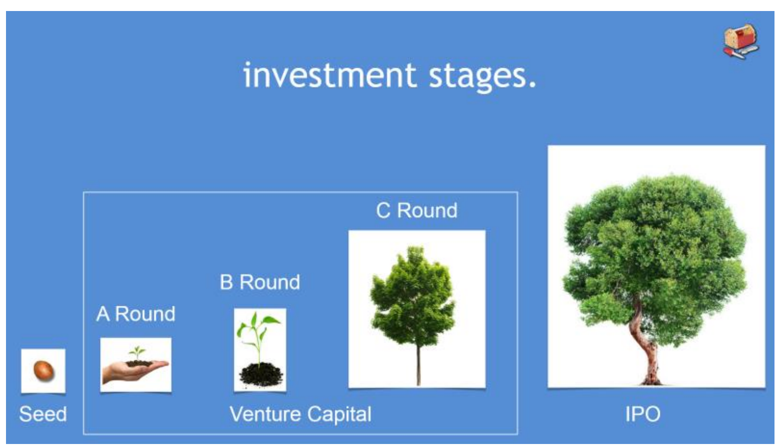
Ideas are commodities. Execution is not. Always bet on the jockey and not on the horse.

WHAT IS VENTURE CAPITAL?

When you start a company you raise money from friends or family members or high net worth individuals (if you can, avoid soliciting money from family and friends). All of these investors in an early stage company are referred to as "seed" or "angel" investors:

Then once your company is huge and usually at least 7 or 8 years old and growth is positive but slowing, then a company goes public through an IPO (initial public offering):

Everything in between the Seed investment and the IPO is what we refer to as venture capital:



Venture capital is usually raised when a firm has been around for more than one year and the company needs access to larger pools of capital to grow. The first time a company raises money from a venture capital firm it is called "The A Round". Then 1 or 2 years later when a start-up needs even more capital to grow then they raise even more money from another venture capital firm in what is called "The B Round". Then in another 1-2 years when the firm needs even more capital to grow, then there is "The C Round". Quite often companies do a D or E round and then they go public. 6 months after the IPO then the venture capital firms are allowed to sell their stake in the company and "harvest" their investment.

About 50% of all venture capital in the United States is based in the San Francisco Bay Area given the plethora of high quality technology engineers, of which more than 60% were born overseas.

There has been a lot of recent interest in the venture capital from institutional investment firms that have historically focused on public only investments. Many publicly focused mutual fund companies are now also investing in the venture capital sector as they are realizing that technology companies are staying private much longer. Many technology companies are staying private much longer as they know that large cap technology companies like Cisco or HP or Oracle no longer have great organic growth prospects (given their size and the law of large numbers). The aforementioned companies have also realized that it makes more sense for them to acquire innovation instead of innovating internally. As a result, valuation has become a bit of an issue in venture capital lately.

How do Venture Capital Firms Make Money?

Venture firms charge an annual 2% management fee that covers their labor and infrastructure overhead.

Venture firms charge a 20% fee on investments that have been harvested through either an IPO or a sale to another company. For example, if you invested $100 in a venture capital fund for 5 years that had a 10x return profile, then you would make $790 as follows

- Management fee = $2 annual management fee x's 5 years = $10 in management fees over 5 years
- Fund carry (or 'incentive') fee of 20% + management fee= $100*10x return *0.20 fee minus the $10 management fees over 5 years = $210 fee for the venture capital firm over 10 years
- Profit for the investor on a $100 investment = 100x10 -210 = $790

Venture capital firms typically look to make 5x's their money in 5 or so years on each company that they invest in. They call this "a 5 by 5". The reason that they have to focus on significant returns is that most of their investments end up not making any money. For every Facebook, there are countless thousands of investments that run out of money and go belly up.

HOW DO I RAISE MONEY FROM A VC FIRM?

In the previous section we covered the basics of presenting to potential investors. That was part of the 30 minute first meeting with a VC firm. You need to also have a condensed 30 second "tweet pitch" which is also referred to as an elevator pitch. This 30 second pitch is crucial as you need it to get your first meeting with a venture capital firm.

Once you get your first meeting with a venture capital firm, you need to sell yourself. They will be assessing you more so than your business model. Give them every reason to believe that you are a superb salesperson and the right passionate leader for your company. If you don't have enough experience, then make sure that your board of advisors do! For more details on how to put together a board of advisors please refer to the networking section of this book. If you are building a tech company, then use your LinkedIn networking skills to get employees of Apple or Google or Facebook, for example, on your board. All you have to do is ask (that's right). Investors will take you more seriously if you have a seriously awesome board.

Make sure to keep your pitch to no more than 10 slides and dumb it down a lot as your investors are not as sophisticated as you think they are. Keep everything in easy to understand language like Steve Jobs did when pitching the iPhone or iPod or iPad to customers. I have a friend in Boston named Rubin Gruber from McGill University who has founded many incredibly successful companies, including Sonus Networks. Before starting any company, he flies up to Montreal and has dinner with his 90 year old mother who is also his best advisor. If he has trouble pitching the idea to his mom, then he either changes his approach or he decides not to launch that company.

Make sure that you are an expert in the market that you are participating in when presenting to venture capital firms. You need to be able to discuss the total addressable market size, your anticipated market share and who your partners, investors and advisors are (name drop if you can). You also need very basic annual revenue and expense line items for at least 5 years.

Show the product by the second slide of the presentation. You will be amazed how many people pitch business models without ever showing the product! By showing the product early in your presentation, your potential investors will have no problem paying attention or understanding your business model. If you confuse them in the first few minutes of a presentation, then you have lost them for good. Why? Because they won't have confidence that you can sell to potential customers! Remember that the best founders and CEOs are incredible sales people like Marc Benioff from cloud company pioneer Salesforce, which is now the largest employer in San Francisco.

Make sure that your pitch and slides are simplistic, elegant and be somewhat entertaining too. Be passionate about the company when presenting. You want to let them know that this is not a job for you. Rather, it is a passion. Keep it simple; less is always more!

Questions Based on Chapter 3:

1: The seed or angel stage comes after venture capital stages.

True or False

2: Venture capital firms have a very short-term investment time horizon.

True or False

3: The quality of the business model is much more important than the quality of the management team.

True or False

CHAPTER SUMMARY