An Entrepreneur's Guide to the Venture Capital Galaxy Dirk De Clercq, Vance H. Fried, Oskari Lehtonen, and Harry J. Sapienza* 2006

Aim of article: provides a foundation for an understanding of the dynamics of venture capital from the entrepreneur's point of view

Introduction

(VC) industry has grown radically in size and sophistication over the last 40 years. In 1978, $424 million was invested in VC funds, while in 2004 almost $21 billion was invested (Gompers & Lerner 2001).

Sources of Capital

For entrepreneurs there are several sources of finance for their new ventures:

- Personal savings
- A second source of capital may come from informal investors, often referred to (somewhat disdainfully) and collectively as the '3Fs' (family, friends, and fools) of new venture financing.
- Another source of funding, at the other end of the spectrum, are banks as providers of capital in the form of loans. However, banks do not wish to assume the high levels of risk associated with equity investing in entrepreneurial ventures.
- In between these two extremes (i.e., an entrepreneur's own capital and informal investors on the one hand, and bank loans on the other), there are three major sources of equity finance available to entrepreneurs:
    - (1) classic or professional venture capitalists (VCs);
    - (2) business angels (BAs);
    - (3) corporate venture capitalists (CVCs).

Venture Capitalists

Invest outside equity from professionally managed pools of money--> raise funds from various parties (primarily institutional investors) who function as limited partners, in an investment pool referred to as a venture capital fund, to maintain limited liability, limited partners are not directly involved in specific investment decision

- A group of VCs who co-manage one or more VC funds is referred to as a venture capital firm
- Most venture capital firms have between $100 to $500 million in capital under management.
- Investment decisions are made collectively by the individual VCs who act as partners of the venture capital firm (for convenience, we refer to the venture capital firm itself as 'firm'and to the investee as 'venture')
- As an industry, classic venture capital firms invest in all stages of venture financing, although some individual firms focus on particular venture stages.
- Compared to BAs VCs invest, but modestly, in seed financings (Wright & Robbie 1998). Seed financings are where the venture is still developing its technology and/or business concept. Funds for a seed financing are used to develop the technology and business concept to the point where the venture can attract start-up financing
- VCs typically focus on the track records of the entrepreneurs

Table 1
Characteristics of VC Providers

	Professional Venture Capitalist (VC)	Business Angel (BA)	Corporate Venture Capitalist (CVC)
Source of funds	● Investing funds of outside limited partners	● Investing their own money	● Investing corporate funds
Legal form	● General partnership	● Private individual	● Subsidiary of a large firm
Typical size of investment	● $2–10M	● $50–100K	● $2–20M
Financing stages	● All stages	● Seed & Startup	● All stages, later preferred
Geographic proximity Preferences	● Close proximity is preferred	● Very close proximity is preferred	● Proximity less important
Motive for the investment	● Equity growth only	● Equity growth and personal	● Strategic and equity growth
Investment criteria	● Growth prospects ● Great management	● Growth and mentoring prospects	● Strategic value and 'fit'
Finding investors Reaching agreement	● Easy to find ● Lengthy and extensive due diligence	● Hard to find ● Relatively quick to reach agreement when 'fit'	● Few but easy to find ● Hard to meet 'fit' requirements
Reporting requirements	● Regularly timed reporting requirements ● Financially focused	● Varies by individual ● Generally light	● Regularly timed reporting requirements ● Strategically focused
Involvement level Method	● Moderate ● Board membership direct or through syndicate	● Low to extremely high, informal	● Low to moderate ● Informal or board
Exit planning Method	● Planned ● IPO/trade sale	● Often unplanned ● Trade sale	● Often unplanned ● Acquisition/trade sale/IPO

Table 2
Issues Related to VC Investing by Venture Stage

	Seed Financing	Start-up Financing	Expansion Financing	Buy-out Financing
Characteristics of the venture	● 1–2 entrepreneurs ● Undeveloped technology and business concept ● Business plan is not validated	● Management team in place ● Product ready for marketing ● A pilot and other information about the product are available	● Marketing has been started ● Venture is ready to start growing and expanding	● Established company
Main purpose of the funding	● Enabling research and development ● Developing business concept	● Establishing the marketing and sales activities	● Launching full scale marketing activities	● MBO ● LBO ● Delisting
Typical venture capital investor	● Business angel (BA) ● Sometimes corporate venture capitalist (CVC)	● VC ● CVC ● Sometimes BA	● VC ● CVC	● VC
Main expertise or benefit beyond money provided by the venture capitalists	● Structure, discipline, sounding board and attraction of additional (external) funding (BA, VC, CVC) ● Insights how to establish the venture's legal form (VC) ● Technological insights (CVC)	● Marketing experience, recruiting help, contacts, help with follow-on financing (VC) ● Technological insights, test marketing and piloting possibilities (CVC) ● Reputation benefits (VC, CVC)	● Marketing experience, recruiting help, contacts, help with follow-on financing, help to plan and execute the exit (VC) ● Technological insights, test marketing and piloting possibilities (CVC) ● Reputation benefits (VC, CVC)	● Legal and other expertise how to execute a buy-out deal (VC)
Major trouble spots of venture capital funding from entrepreneurs' point of view	● Time consuming to locate, negotiate and close the deal ● Involvement (e.g. reporting requirements and governance) with a VC requires a lot of time ● Early stage company does not have very much to back up the valuation of the venture and the valuation might be very low	● Time consuming to locate, negotiate and close the deal ● Involvement (e.g. reporting requirements and governance) with a VC requires a lot of time ● CVC might want to direct the strategy of the venture	● Time consuming to locate, negotiate and close the deal ● Involvement (e.g. reporting requirements and governance) with a VC requires a lot of time ● CVC might want to direct the strategy of the venture	● Time consuming to locate, negotiate and close the deal, ● Involvement (e.g. reporting requirements and governance) with a VC requires a lot of time

Business Angels
Business angels (BAs) are individuals who invest their own capital in new ventures. BAs are often either entrepreneurs (who have sold their companies and wish to invest their money) or retired senior executives of large companies.

- BAs share the VC's interest in equity growth, but many are also drawn to venture capital investing by the chance to be heavily involved in an exciting venture where they have the opportunity to leverage their industry contacts and expertise and/or to mentor the development of a promising young entrepreneur.
- BAs are inclined to invest in businesses where they have knowledge and experience (Harrison & Mason 1996)
- An important issue for the entrepreneur will be to determine whether the BA's primary interest is to generate a profit or to mentor as well.
- Typically, BAs will take modest levels of ownership in the new venture, averaging 10 to 15
- percent of ownership in initial deals.

Corporate Venture Capitalists: acts as a financial intermediary of a non-financial company (Siegel 1988).

- CVCs are interested in equity growth on their venture investment, their primary interest is in securing strategic benefits for their parent operating company
    - For example, the CVC of a pharmaceutical company may invest in a start-up that is developing a new drug that its parent company will ultimately distribute
- corporate venture capital investments are primarily made in ventures whose line of business is closely linked to the parent's existing business.
- Entrepreneurs should be aware that a CVC whose parent is well-recognized in the marketplace can provide substantial benefits such as access to distribution channels, R&D support, and direct sales to the mother company
- From the entrepreneur's point of view, a major danger with CVCs is the appropriation of technology secrets or know-how by the CVC
- Entrepreneurs should be aware that VCs, BAs, and CVCs represent partially complementary and partially overlapping sources of finance
- involves two dimensions—namely, the timing and amount of capital provided. BAs tend to be more willing than VCs to invest at the very earliest stages; however, the amount of funding available for a single infusion is much larger from VCs and CVCs than from Bas

The Venture Capital Investment Cycle: three phases can be distinguished in the VC investment cycle(Tyebjee & Bruno 1984):

- <u>pre-investment:</u> VCs' goal in the pre-investment phase is to make an investment in a venture that offers the potential for significant long-term capital gains. Their target rates of return are about 30 to 60 percent per annum; thus, to qualify, a venture must have a realistic chance of achieving significant growth in sustainable earnings and offer an exit opportunity in three to seven years after the investment (Sahlman 1990).
    - For entrepreneurs they need to understand what VC look for: In essence two aspects are important. First, the venture needs to offer an excellent business opportunity. VC would define such opportunity as huge market potential; appropriate venture strategy with a goal of establishing and maintaining

uniqueness; adequate protection of intellectual property from imitation; and a well-developed and integrated marketing, production, and financial plan (Shane
    - 2003)
    - VCs look for a concept that can be implemented in a reasonable time with a reasonable amount of capital
    - One study says: VC's decision-making process: the entrepreneur's educational capacity (i.e., the availability of general skills that enable the perception of, and enactment upon, market opportunities) and industry-related experience (i.e., the presence of considerable experience within the management team in terms of the industry that is being entered by the venture) (Shepherd 1999) other study mention: completed product development project or funding round; experience etc.
    - The VCs process is generally: deal origination deal screening, deal evaluation, and deal structuring. The process generally takes the VC in excess of 100 hours of work over about a three-month timeframe before making an investment.
    - VCs are much more apt to invest in deals that are based on referrals, rather than in deals that come in cold
    - a VC may invite a BA to invest in a start-up in an industry where the BA has significant experience. The VC does not want the BA's money; rather, the VC wants the venture to benefit from the BA's industry expertise and contacts
    - VCs may also include a variety of covenants in their agreements with entrepreneurs. For instance, they may prohibit the entrepreneur from purchasing assets or issuing or selling shares without their permission. They may also demand mandatory redemption rights that require the venture to purchase their investment back.
    - A particularly important issue for many entrepreneurs is the common practice among VCs to stage their investments across multiple rounds of financing. VCs prefer to stage their investments because this reduces the amount of money invested at the earliest stages of development when
    - risk is highest (Sahlman 1990).
- <u>post-investment:</u> VC is essentially engaged in two types of activities: monitoring and providing value added.
    - VCs often engage in staged investing, and generally invest in convertible preferred stock that carries the same voting rights as if it had already been converted into common stock (Gompers 1998).
    - entrepreneurs should also understand that most VCs do not want to tell entrepreneurs how to make day-to-day operations nor have them report on a daily basis. They basically want the entrepreneur to run the venture profitably; they want merely to be consulted on any major decision (Gifford 1997)
    - VC serves as a 'sounding board' to the entrepreneur and the venture's top management on a variety of key decisions in the life of the venture. Rather than making decisions for the entrepreneur, the VC prefers to provide advice to the entrepreneur, reflecting on the entrepreneur's ideas and making suggestions (Sapienza 1989)
    - The CV will take the following roles in this phase: Strategic, mentoring, financing, networking, interpersonal, reputational, Discipline role
- <u>Exit phase</u>: VCs insist on a clear exit strategy that enables them to convert their non-liquid equity position in a private company into cash or publicly traded stock.
    - Exit generally occurs by:

- (1) the venture going public (IPO) and the VC selling his or her stock in the public stock market;
- (2) the venture being sold (trade sale) in its entirety;
- (3) the venture buying back the VC's stock;
- (4) the venture being liquidated and the proceeds, if any going to the VC after creditors have been paid off.

Maximizing the Entrepreneur-VC Relationship- guidelines for entrepreneurs

Table 4
Maximization of Value in Entrepreneur - VC Relationships

Pre-investment phase	*Post-investment phase*	*Exit phase*
● Getting venture capital ● Secure a good referral ● Write a good business plan ● Be prepared for the meeting ● Don't (over) shop/don't (over) rely ● Be honest, but sell ● Have patience ● Get the right venture capitalists ● Complementary skills ● Commitment ● Trusting relationships ● Obtain the right amount of money ● Structure a fair deal	● Respect the VC ● Formal legal power ● Money power ● Deserve VC attention ● Respect yourself ● Communicate ● Be trustworthy ● Remain as objective as possible	● Avoid pre-mature exit ● Exit harmoniously

Figure 1
Steps in the Investment Cycle

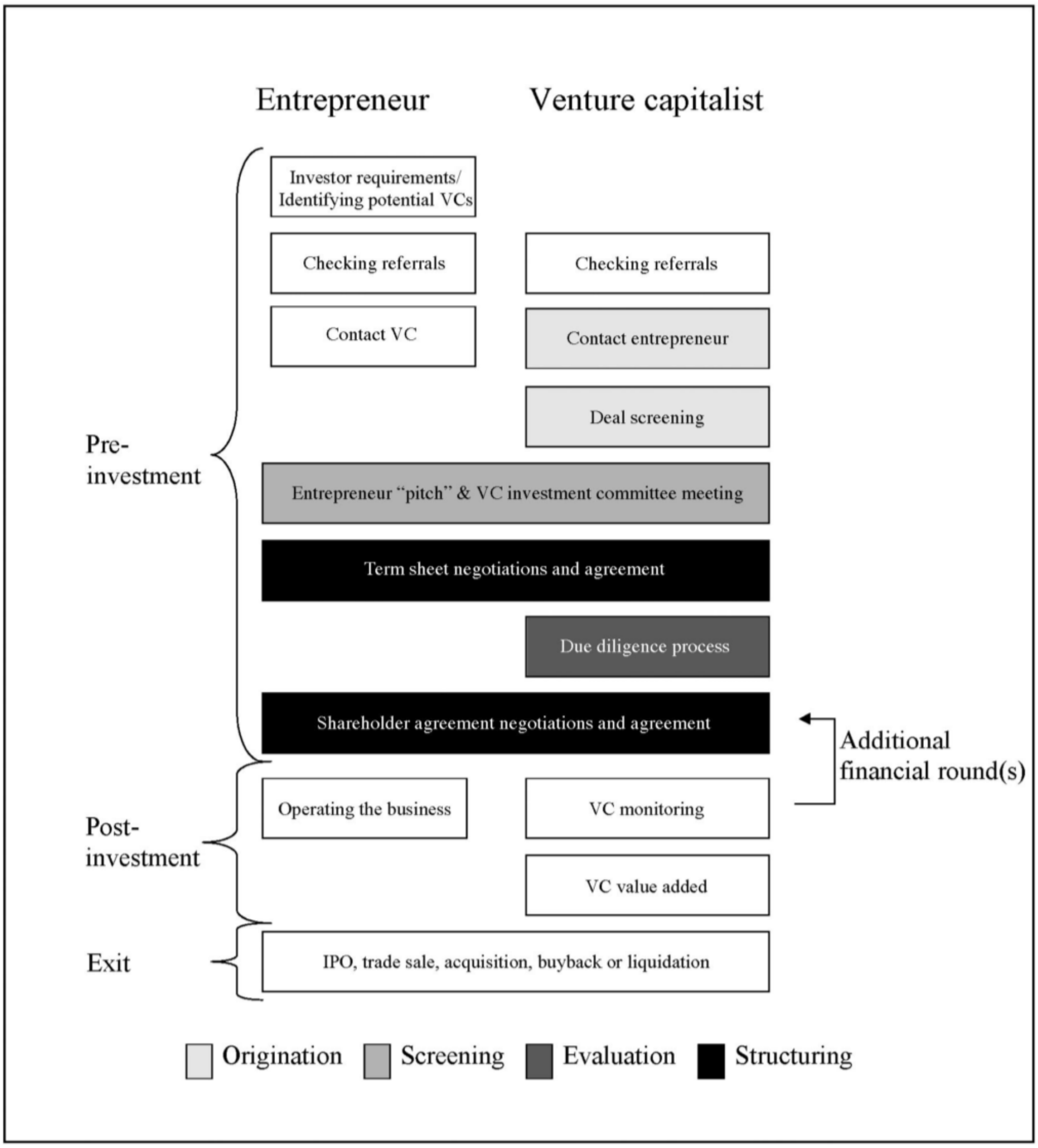

Table 3
Issues by VC Type and Investment Phase

	Professional Venture Capitalist (VC)	Business Angel (BA)	Corporate Venture Capitalist (CVC)
		Pre-investment phase	
Deal origination	● VCs tightly knit community ● Referrals are highly valued	● BAs hard to locate ● Internet, informal networks and university groups may be used	● CVCs usually 'tag along' with VCs ● May be best to find VCs that regularly partner with CVCs
Deal screening	● Defined targets ● Check stage, industry, location, and capital needed ● Formal pitch	● Difficult to know a priori what investor's preference is ● Typically informal pitch	● Multiple strategic foci ● Formal pitch
Deal evaluation	● Extensive due diligence	● Criteria/process investor specific	● Extensive due diligence (proprietary knowledge at issue)
Deal structuring	● Valuation ● Formal control by the VC ● Use of 'term sheet' ● Staged investing	● Fewer restrictive terms ● Lack of sophisticated terms may cause later financing problems	● Follows VC lead ● Intellectual property rights are key issue
		Post-investment phase	
Monitoring	●Milestones ● Board representation ● Reporting requirements for entrepreneur	● Informal control	● Corporate control
Value-adding roles	● High to moderate ● Roles: strategic, financing, networking, interpersonal, reputational, discipline	● Low to moderate	● High to moderate
		Exit phase	
Exit planning	● Planned	● Often unplanned	● Often unplanned
Exit mode	● IPO/Trade sale	● Trade sale	● Acquisition/Trade sale/IPO