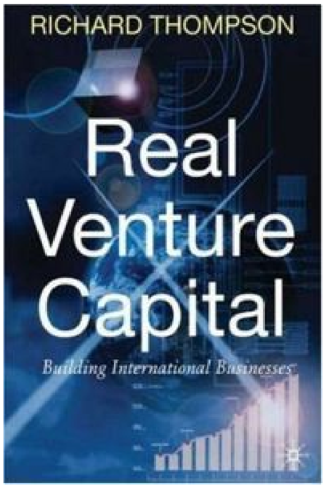

Book Real Venture Capital

Building International Business

Richard Thompson
Palgrave Macmillan, 2008

Recommendation

This brief book offers a sound introduction to the fundamentals of venture capital investing. Though it emphasizes the United Kingdom, it illustrates the state of the venture capital business in other nations as well. Richard Thompson gives a straightforward explanation of what "real venture capital" is. He distinguishes venture capital for new business development from private equity, or refinancing, for established companies. Case studies and anecdotes from the author's own experience support his plain, commonsense recommendations. While this book will be particularly appropriate for readers in the U.K., *BooksInShort* also recommends it to any reader seeking a short, practical guide to the business of investing venture capital.

Take-Aways

- "Real venture capital" helps new businesses grow. The investors act as "partners" of the entrepreneurs or managers of those businesses.
- Private equity that is invested in established businesses is not venture capital.
- Venture capital investors need to balance their gut instincts with analytical discipline.
- Venture capitalists should be prepared for a long-term investment horizon, but can expect very good returns.
- Venture capitalist must have a solid understanding of business basics.
- Young companies should specialize in a niche, focus on quality and build an international market.
- A new company can gain domestic market share and then move into international markets more easily in the United States than in the European Union.
- Managing currency risk and other international business complexities requires knowledgeable, professional advice.
- Health care and technology are fast-growing industries with international scope, which makes them well-suited for venture capital.
- Directors have become more independent of managers in recent years.

Summary

Venture Capital and Private Equity

Investing venture capital can be a high-return, low-risk business. But the term "venture capital" has many connotations, not all of them positive. In the United Kingdom, venture capital investment is widely denounced as a game for fast buck artists. But "real venture capital" helps new or existing companies grow; the investor acts as a "positive partner to the entrepreneurs and executives" of those firms. The U.K. economy needs companies that begin small, grow and expand abroad. The government cannot stand in the place of venture capitalists because it acts too slowly, even when business conditions demand rapid action.

> "Venture capital, properly practiced, is a long-term business, a partnership with entrepreneurs and executives."

Investors of real venture capital commit to collaborate over the long term with company founders and managers. They bring valuable insight and expertise to businesses. Typically, venture capitalists aim for fat returns on investments in common equity. When venture capitalists own common stock, their interests are aligned with those of other common shareholders.

> "Institutions need to put more money into real venture capital, partly because the buy-out market is overcrowded."

In the U.K., disappointing returns on venture capital investments in new businesses led to increased infusions of private equity in existing businesses. An example of this type of investing is the leveraged buyout, that is, the use of borrowed money to buy a business. Private equity is a valuable form of business financing, but it cannot replace venture capital since it cannot generate as much economic activity as venture capital. Private equity groups that invest in ongoing businesses create nothing new. Nevertheless, private equity groups compete vigorously with venture capital groups for investors' money.

> "Usually the key to success for a young growth company is to have a narrow product focus and to exploit this as widely as practicable in the international market."

After World War II, modern venture capital blossomed in the United States, where the domestic market is large, and the culture favors risk-taking. Venture capital investment became a more common form of financing during the 1960s, especially for technology companies in the Palo Alto, California, area. In the U.K. and in continental Europe, conservative risk aversion has stymied the development of venture capital.

Types of Venture Capital

Venture capital takes the form of "early-stage," "second-round" and "third-round" investments. The risks and rewards of these three types vary according to the company's stage of development. Early-stage investments can be highly rewarding but quite risky, especially if the company does not yet have any revenue or profit. Entrepreneurs who passionately pursue great ideas run the best start-ups. They require small capital commitments, with additional capital contingent upon satisfactory results.

> "The U.S. is the easiest market in which to build a new company, since a base can first be established in the domestic market and then, from strength, the company can strike out into the international one."

Second-round investments of venture capital usually go to companies that are profitable. Although the risk is moderate, the potential rewards can be very attractive. Companies in this stage generally require more capital than early-stage ventures, but the lower risk justifies a larger investment.

> "Having good professional advisers when dealing with overseas companies and investors is a 'sine qua non'."

The ideal candidate for a third-round investment of venture capital would be a company with a solid domestic market and growing international markets. The risk is low and the potential reward high. While organic growth is best, business acquisitions for strategic or tactical reasons may be advisable.

Where to Put Venture Capital

A successful venture capitalist targets industries and geographic markets with high growth rates. Building a new business is not as hard in the U.S., for example, as it is in the U.K. or in Europe. Heretofore, most venture capital investing has occurred in developed countries. Global trends suggest that more venture capital opportunities will evolve in China, India and other emerging countries.

> "The recent rapid expansion in venture capital in the U.K. is likely to be followed by a period of shake-out."

Health care and technology companies in the U.S. are particularly attractive candidates for venture capital. Young companies in those fields can succeed by building a reputation for quality, getting established in the domestic market and then expanding abroad. In the early stages, technology companies require less capital than health care companies but may face greater competitive threats.

> "From an investment standpoint, instrument companies can offer low risk/medium reward opportunities with a good degree of stability. Those which involve very high cost items are, however, to be dealt with warily."

Successful companies often use venture capital to fund innovative product development. This can be "market-led," that is based on connections and a thorough knowledge of market trends, or "product-led," which may require patent protection to penetrate markets and to defend against competitive incursions.

> "The main opportunities for venture capital investment in the pharmaceutical sector are in services companies."

Investments in employees may be the biggest that health care and technology companies make. Winning companies make sure that all of their employees have adequate training, understand the mission and know through regular performance reviews how well they are performing. Companies also must invest in property and equipment, but they should perform disciplined analysis and use solid decision methodologies.

Entrepreneurs, Managers and Directors

Depending upon their stage of development, businesses tend to rely primarily on entrepreneurs, managers or directors. People in each class of leaders have distinguishing personality traits. Entrepreneurs often start businesses as a means of self-expression. They can be positive, loyal and generous. They also can be defensive and vengeful. Money is not their primary motivation. They long, instead, for the broad recognition that a great idea attracts.

> "The issues that normally cause the most trouble and steam on a deal relate to financial and legal matters."

Managers are indispensable as a company grows. The best ones are steady team players, detail-oriented and trustworthy. They are more analytical and less intuitive than entrepreneurs. Ideally, managers balance the instincts and drives of entrepreneurs. When management is excessive, companies suffer.

> "The role of boards has changed but their structure and operating methods have not."

The role of the board of directors has changed in recent years. Directors face greater accountability for negotiating priorities among various stakeholders. Companies that seek broad representation on their boards tend to put more emphasis on social responsibility. Independent directors unaffiliated with management hold most board positions at larger companies. The board should ensure that enough checks and balances are in place to protect the company from executive errors.

Controls, Cash Flows and Compensation

Financial processes and controls are particularly important for a young business feeding on venture capital. Simple, straightforward financial structures work best. Companies should avoid complicated tax-avoidance strategies that introduce needless organizational complexity. Profitability is an important measure of performance, but from a venture capitalist's perspective, cash flow is the single most important financial metric, especially for companies in trouble.

> "Intuitive judgment is vital in selecting investments, but it must be backed up by relevant tactical data."

When borrowing makes sense, the company can take on debt. However, start-up companies should avoid leverage as much as possible. Start-ups have a hard enough time generating cash flow to cover operations without worrying about debt service.

Stock options may be the most appropriate way to compensate key employees and keep them on board for the long term. Options typically vest over a period of years after the award dates, requiring the employees who hold them to wait for the payoff. However, be judicious when choosing this form of compensation and pricing the options.

Investing in Business Turnarounds

Business turnarounds are necessary when investments fail to perform as expected. Public companies in need of a turnaround are better off going private in order to keep the necessary surgery out of the public eye. Investors in turnarounds often exit either by taking the company public again or seeking another private buyer.

> "Options and warrants are...the only way in which staff can be brought into the equity on reasonable terms."

Patience is not a virtue among venture capital investors in distressed businesses. No investment is warranted unless the troubled company can turn itself around quickly. One common mistake is underestimating the length of time a turnaround can take.

Getting rid of the upper-level managers responsible for leading the company into trouble is a common first step. Many companies have solid, lower-level managers who can step into the vacated senior posts. The goal of a turnaround is to raise margins, often by lowering overhead. Possible cures include dumping poorly performing products and terminating unproductive staff and, perhaps even selling whole business units.

> "My main argument with forms of private equity other than venture capital is not in what they do, which is often valuable, but that they mop up a large amount of the capital for new ventures."

Managers best qualified to run turnarounds are financially astute and have an intense short-term focus. This will not be the same kind of manager who is most appropriate for running a business over the long term.

Going Public

A public offering is the preferred exit strategy among many venture capitalists. A public offering can provide a market test to assess the value of a company and thereby facilitate a private sale farther down the line. The IPO price will depend on growth, productivity and future prospects. Rushing the process may be unrewarding, though. If you take a company public prematurely, you will regret it.

The company should exercise caution in selecting its investment bank. Ideally, the investment bank's work on the IPO will become the foundation for a long-term relationship. A successful initial offering could enable the company to work with the investment bank to raise additional equity capital in a secondary offering of stock.

Initial public offerings are likely to succeed if the company has a stable business, solid management and sound governance. Preparing for life as a public company is part of getting ready for an IPO. Selling stock to the public puts additional regulatory scrutiny on a company, heightening the need for a well-qualified corporate finance staff to work with shareholders and handle public reporting duties.

Alliances and Acquisitions

Alliances allow smaller companies to build the credibility necessary to compete for major contracts. Alliances in the health care and technology industries allow smaller, niche companies to focus on core competence in, say, product development, leaving marketing or manufacturing to bigger partners. Alliances between companies in the same size range may involve reciprocal arrangements to sell each other's products.

Alliances may give way to acquisitions. But acquisitions sometimes fail to deliver benefits as expected. An economic and cultural fit is required for the deal to succeed. Acquisitions disappoint investors if the anticipated synergy proves to be a mirage. Before completing an acquisition, exercise due diligence with rigorous discipline and a clear focus on the facts.

Acquisition prices may be denominated in cash or stock, or both, and no sale can proceed until buyers and sellers agree on terms. Investment banking services and legal services are required if at least one party to the deal is a publicly held company. Legal services alone may be enough to consummate a business acquisition if both parties to the transaction are privately held companies.

Whatever their exit strategy, venture capitalists play an important role in economic development. But positive investment results are hardly guaranteed. In the U.K. and the U.S. and beyond, venture capitalists succeed or fail based on their skill and discipline in evaluating, executing and protecting investments.

About the Author

Richard Thompson is a Cambridge science graduate who subsequently qualified in both chartered engineering and management consultancy. He has co-founded and chaired several successful venture capital firms over a 30-year span.