Worth the risk

How to win venture capital funding

Venture capital is relatively scarce and the competition for it is intense. Here NICHOLAS HUMPHREY gives an overview of the venture capital process from the entrepreneur's standpoint. A following article focuses on the reasons for the slow acceptance in Australia of venture capital as an investment sector.

Nicholas Humphrey ASIA is a specialist venture capital lawyer with Gilbert & Tobin who has acted on a large number of venture capital investments for both investors and entrepreneurs. He is a member of the Australian Venture Capital Association Limited and the Securities Institute of Australia. This article is based on a chapter from his book The Business Startup Guide, which is being published by Penguin Books Australia and is due for release in late 2000. The author acknowledges the assistance of Jim Kuiper and Melanie Howard of Gilbert & Tobin in researching this article.

Venture capital involves the provision of funding, by way of an equity or debt investment, to rapidly growing unlisted companies. Venture capital investors not only provide capital but also offer value-added services in the form of strategic advice, introducing alliance networks and facilitating exit strategies.

Venture capital is often called "patient capital" as it seeks a return not through immediate and regular payments of principal and interest, but through long-term capital appreciation. Venture capitalists realise their investment when they sell their shares in the company through an IPO or a trade sale (known as a "liquidity event"), typically between three and five years after the investment (although longer periods may be acceptable in biotechnology investments).

In a venture investment, the founder of a company trades an agreed percentage of shares in the company in return for funding. Venture capitalists usually take a minority stake and do not control the day-to-day affairs of the company.

To compensate for the long-term commitment and a lack of liquidity and security, venture capitalists expect to receive very high returns for their investment. They therefore invest mostly in companies with high growth potential.

KEY CHARACTERISTICS

Venture capital investments tend to have the following key characteristics:

- new marketing ideas, innovative technology and new product application potential;
- a significant, although not necessarily controlling, participation by the venture capitalist in the company's management;
- high-quality executives and employees who are energetic, focused and professional;
- products which have passed through the early prototype stage and are adequately protected by patents, copyright or confidentiality arrangements;
- businesses with the potential to mature within a few years to the point of an IPO or trade sale;
- opportunities for the venture capitalist to make a contribution beyond the capital investment.

Figure 1 summarises the venture capital investment process from the perspective of the entrepreneur.

Venture capitalists have historically concentrated on high-growth, high-value sectors such as information technology, biotechnology and other fields which have the potential to offer an optimal rate of return. Many venture capital firms specialise in a particular market segment (such as dotcom or telecommunications) where their unique skills can be of most value to companies.

Traditional debt finance is usually unsuitable for a startup company. The business plan often requires large amounts of money to be spent early to establish the business before a revenue stream can be established, and the company may not be able to make the regular interest payments demanded by debt finance and may not have the assets necessary to secure a loan.

Table 1 sets out the relative differences between debt and venture capital financing from the investor's perspective.

The 2000 *Guide to Venture Capital in Asia* lists the total Australian venture capital pool at just over $A5 billion, with 85 firms currently in the venture capital market. Those firms invested in 313 companies in 1998. Figure 2 depicts the growth of the Australian venture capital pool (ie, total of all funds under management) from 1991 to 1998.

Venture capitalists can provide the following value-added services to companies:

Mentoring — venture capitalists provide companies with strategic, operational and financial advice. They will typically have nominee directors appointed to the company's board and often become intimately involved with the strategic direction of the company.

Alliances — venture capitalists can introduce the company to an extensive network of strategic partners, domestically and internationally, and may also identify potential acquisition targets for the business and facilitate the acquisition.

Facilitate exit — venture capitalists are experienced in the process of preparing a company for an initial public offering (IPO) of its shares on the Australian Stock Exchange (ASX) or overseas stock exchange such as NASDAQ. They can also facilitate a trade sale.

STAGES OF INVESTMENT

Growing companies need capital at several different stages. The characteristics and needs of the company are different at each stage, as are the risks and the returns for the investor. Venture capitalists categorise companies into four stages of growth — seed, startup, expansion and mezzanine.

Stage one — Seed: At this stage the business is little more than a concept. The product is usually still in development and the company is concentrating on research and on producing a working model or prototype. Often the founders of the company will use their personal assets and loans from family or friends to meet the funding needs of the company, normally between $50,000 and $500,000.

Stage two — Startup: The startup stage is also known as the "angel round". The concept or products have been developed, but the company has no track record and often has not made a profit. This is the riskiest stage for investors as the company needs a large amount of capital but has no reliable indicators of its future success. Many businesses will fail during this phase. At this stage the funding needs of the company are typically between $500,000 and $2 million. Depending on the industry, the startup stage can last between six months and several years.

FIGURE 1 **The venture capital investment process**

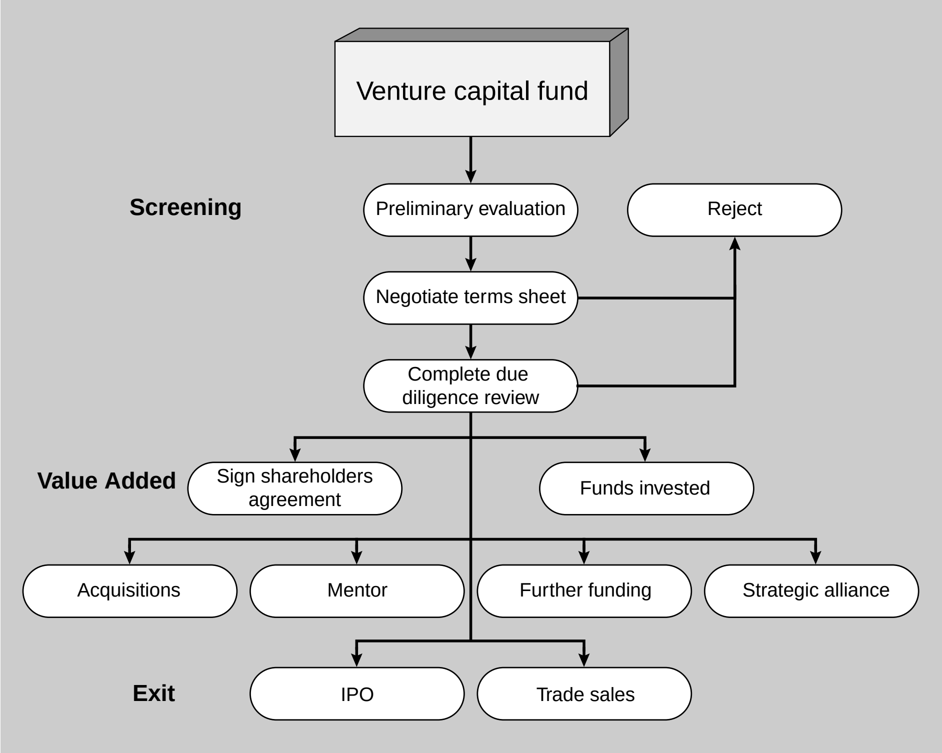
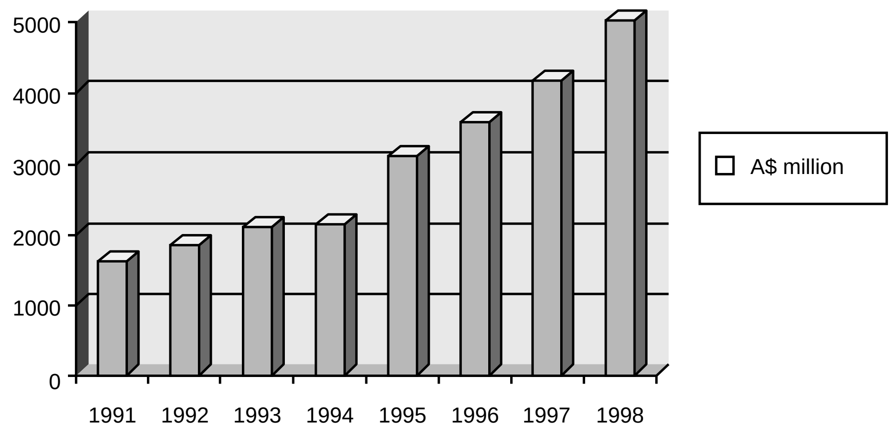


TABLE 1 **Features of venture capital financing**

	Debt financing	Venture capital financing
Form of investment	The company borrows money which it has to repay later, with interest	In return for the funds, the investor receives a percentage stake in the capital of the company
Investor's source of return	Interest	Growth in the value of the investor's shares
Return on investment	5-10% per annum	An internal rate of return (IRR) of 35-40%
Protection for investor	Mortgage over the assets of the company	Board seats, preferential shareholder rights, put/call options
Risk	Low	High to very high
Considerations for investor	Adequacy of collateral	Growth potential of company
Time before investor generates income	Usually 1 month	Typically 2-6 years
Means of exit for investor	Loan repayment	IPO or trade sale

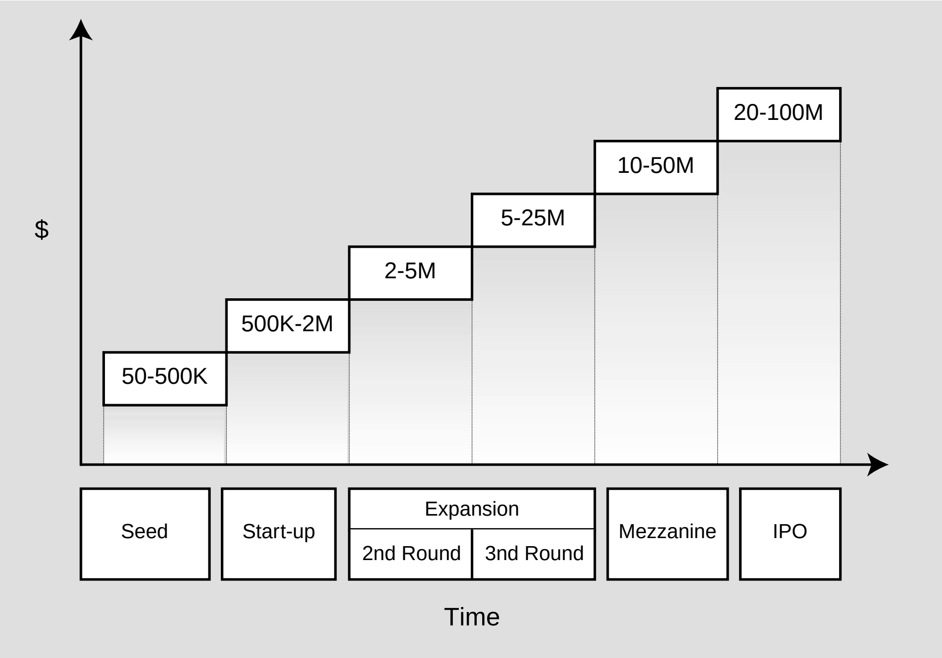
Stage three — Expansion: This is often called the "second round" and may indeed comprise multiple rounds before the company is ready for stage four. By the expansion stage, the company is fully set up and building a financial track record, and

FIGURE 2 **Growth of venture capital in Australia**



Source: Australian Venture Capital Journal, 2000

FIGURE 3 **Stages of venture capital investment**



needs funding to expand its operations and marketing. At this stage the funding needs of the company are typically between $2 million to $10 million plus. Some companies choose to meet their financing needs at this stage with traditional bank finance; however, the bank will usually require collateral and personal guarantees from directors.

Stage four — Mezzanine: Mezzanine funding or pre-IPO funding enables the company to prepare for an IPO. The funds may be used to make a few strategic acquisitions and mezzanine investors can provide experience in the IPO process. For example, they may "dress up" a company for listing by introducing recognised business people to the board. At this stage the funding needs of the company can be anywhere from $10 million to $50 million and up.

These stages of investment are set out in Figure 3, which also indicates the level of funding typically required.

THE INVESTMENT PROCESS

The typical venture capital investment process involves these steps:

- Prepare a business plan
- Select suitable venture capital funds
- Submit your business plan for evaluation
- Negotiate valuation
- Negotiate a terms sheet
- Due diligence investigations
- Negotiate and execute formal investment documentation

Prepare a business plan

Venture capitalists have several thousand business plans submitted for evaluation every year and may have hundreds under consideration at any time. Even a truly innovative business will not be considered unless the business plan is professionally and comprehensively prepared.

A business plan should set out all the key facts about the business — its business activities, the financial plan, the industry in general, competition, customers and how resources will be used to achieve the business objectives. Venture capitalists will pay particular attention to the management team and its relevant experience and qualifications.

Most venture capitalists prefer business plans to be limited to 15 or 20 pages. Any material not essential to the company's message should be eliminated or attached in an appendix to the plan.

Companies should avoid plans that pursue simultaneous opportunities in different markets. Venture capitalists prefer companies with a focus on the greatest opportunity and the objective of doing that well. Other opportunities can be discussed later or handled in a brief section toward the back of the plan.

Selecting a venture capital fund

A company should consider the investment preferences of the various funds, the quality of the relationship between the management team and the investors and the ability of the fund to provide future financing.
In choosing a venture capital investor, the factors shown in Table 2 should be considered.

Submitting a business plan

A good business plan alone may not be enough to make a proposal stand out. It is useful to seek an introduction by a person who knows the venture capitalist. Friends or associates who have previously obtained venture capital financing, government laboratories and other entities that license technology may all have connections to venture capitalists. Accountants, lawyers and bankers who advise venture capital funds or companies are also a good bet, as well as superannuation fund managers, universities and other entities involved in innovation and venture capital.

Once a number of suitable venture capital funds and, if possible, an "introducer" have been identified, the business plan can be submitted for evaluation. The venture capital fund will undertake a preliminary evaluation of the merits of the proposal, in particular:

- experience of the management team;
- potential for exit;
- profitability of the business;
- outlook for the industry;
- competitiveness of the product/services;
- barriers to entry; and
- viable business model.

Valuation of the business

Negotiating valuations can be one of the most difficult issues in a venture capital financing. Valuing a company is never easy, but it is especially difficult in the case of a startup without any operating history.

Venture capitalists will often base their valuations on a management's own projections and on deals negotiated by other companies in the industry. Information about comparable companies which have received venture financing can be useful in setting benchmarks for valuation. The investor will want to ensure that the valuation is supported by financial and legal due diligence and that the company's forecasts are reasonable and based on sound assumptions.

Although valuation is of obvious importance, other issues (such as restrictions on the founder's shares, the investor's ability to introduce strategic partners and the preferential rights attaching to the investor's shares) should be considered as well.

The venture capitalist willing to pay the highest price is not necessarily the best venture capital fund for the business. Another venture capitalist willing to pay less may be a better partner in dynamically growing the business.

The terms sheet

TABLE 2 **Choosing a venture capital investor**

Investment preferences	You should look at the investment preferences of the various venture capital funds: • particular stages of investment • amount of investment • industry sectors • geographic allocation
Communication	As the investment will probably last for a number of years and involve close negotiations and discussions, it is important to select a fund with which a strong and open relationship can be established.
Experience	What other companies in the industry have they invested in, and what has their track record been?
Future funding	Can the investor provide further rounds of funding? Can they introduce you to offshore finance markets?
Value-added services	Does the fund offer any of the following: • industry-specific knowledge • financial and strategic planning • recruitment of key personnel • acquisition identification • access to international markets and technology
AVCAL	Is the fund a member of the Australian Venture Capital Association Limited (AVCAL)? This association has adopted an industry code of conduct which establishes minimum principles that members are to observe.
Other investors	Would the venture capitalist be willing to work with other investors? Are there other venture capital firms they think should be invited to co-invest in the deal?
Time horizon	What is the exit time horizon for the investment?

The terms sheet sets out the basic framework for the deal. Issues to be resolved at this stage include the form of the investment, protections to be given to the investors, rights of the investors to appoint board representatives, information rights, pre-emptive rights and exit strategies.

The terms sheet will govern the investment until the parties negotiate the detailed legal agreements. It focuses the parties on the major issues early in the process, saving time and expense in drafting the later formal agreements.

In drafting the term sheet, it should be kept in mind that the company is likely to need subsequent rounds of financing. Future investors are likely to want the same rights as those granted to early-round investors, and the company should weigh the implications of this in negotiating the early rounds. The following issues may arise in the negotiation of the terms sheet:

The form of the investment consideration: The consideration for the investment may take the form of ordinary shares, preference shares or convertible notes. Venture capitalists generally want preference shares as they confer additional protection without leveraging the balance sheet.

Size of investment and tranches: Venture capitalists may wish to make their investment in stages or tranches with each tranche conditional upon the company achieving certain milestones.

Number of directors: Venture capitalists will want to oversee and control the progress of their investment. To do this, they will seek to appoint directors and tailor the matters which must be considered by the board.

Protection against dilution: There are two types of anti-dilution protection:

- Restructures — protection against share splits, consolidations and similar recapitalisations occurs by adjusting the conversion price of preference shares to ensure that the number of ordinary shares issued on conversion represents the same percentage of ownership; and
- Price protection — if the company issues shares at a discount to the shares bought by an investor, the conversion ratio is adjusted to ensure the number of ordinary shares issued on conversion represents the same percentage of ownership.

Redemption: Venture capitalists may seek the right to force the company to realise the value of the investment at some point in the future by requiring the company to buy back or redeem their shares if an IPO or trade sale has not occurred by a certain date.

Facilitation of sale of all issued shares: Venture capitalists may also require a "drag along" clause which compels all shareholders to sell their shares if more than a specified percentage of shareholders (usually 75%) accept a third-party offer.

Standstill for founding shareholders: Venture capitalists may require that the founding shareholders agree to a standstill provision which prevents them from selling their shares in the company for a period of time.

Executive service agreements: Venture capitalists may require that key executives sign appropriate executive service agreements.

Information rights: Venture capitalists may want the right to receive certain information, such as monthly financial statements, annual audited financial statements and the annual budget and business plan approved by the board.

Intellectual property rights of the company: Venture capitalists may want assurance that the company has sole legal and beneficial ownership of the intellectual property rights.

Pre-emptive rights: Venture capitalists may require a pre-emptive right to invest in future issues of shares in preference to a third party.

Exit strategy for investors: Venture capitalists are driven by the need to realise the value of their investment and may seek to impose a provision enabling them to force a trade sale or IPO if such an event has not occurred within three or four years of the investment.

Additional management members: Venture capitalists may require the company to recruit additional executives to the management team.

Exclusivity period: The venture capitalists may seek a period of exclusivity after the signing of the terms sheet, typically in the region of 30 to 60 days, where the venture capitalist has the right but not the obligation to invest.

Due diligence

Due diligence involves a detailed examination of the company. The due diligence process will run in parallel with the terms sheet negotiations.

Generally, the venture capitalist and its lawyers will undertake the following due diligence:

Corporate: A review of the company's corporate structure including subsidiaries, business names, constituent documents, shares issued and debt securities convertible into shares.

Assets: A review of assets owned by the company, including real property, intellectual property, contractual rights and intangibles, a list of who owns the assets and any mortgages or charges over them.

Intellectual property: Ownership of the intellectual property will be verified.

Financial statements: The financial statements and accounts of the company will be reviewed extensively to assess the past performance and prospects of the business.

Material contracts: A review of the company's key contractual relationships with suppliers and customers, key employees, strategic alliances, licensing agreements.

Employees: The company's standard employment agreements, relationships with key employees, employee option plans and the history of any disputes.

Litigation: Any actual or threatened litigation or dispute in which the company has been involved.

Execute legal documentation

Assuming the due diligence has not uncovered major issues relating to the prospects of the business, the parties will then prepare and sign formal documentation which sets out the detailed mechanics for the issues set out in the terms sheet.

The legal documentation varies, but in most cases will include:

Subscription agreement: This sets out the subscription details such as number of shares, price of shares, the number of tranches and dates of subscriptions. It will also contain detailed warranties about the company, rights attaching to shares, and any conditions which have to be satisfied before the investment is made.

Shareholders agreement: Sets out the ongoing relationship between the shareholders and the company as agreed in the terms sheet.

Intellectual property acknowledgment deeds: An acknowledgment by other parties that they have no rights in any intellectual property which they developed and assign all such creations to the company.

Executive service agreements: Will bind key employees to the company for a period (usually two or three years) and will set out the employees' terms of service, remuneration and bonus entitlements.

This article has provided an overview of the venture capital process. A venture capital financing is a complex transaction and involves significant commercial risks for both the company and the venture capitalist. It is crucial to be aware of the issues and the potential impact they have on the future of the company. J