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A PRACTICAL GUIDE TO VENTURE CAPITAL FUNDING FOR EARLY STAGE COMPANIES

A COURTESY GUIDE PREPARED BY SWAAB ATTORNEYS

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Introduction to venture capital investment

Venture capital is money provided by outside investors for financing new, growing or struggling businesses. Venture capital investments are generally high risk investments but offer the potential for above average returns. A ***venture capitalist (VC)*** is a person who makes such investments. A ***venture capital fund*** is a pooled investment vehicle (often a partnership or trust) that primarily invests the money of third party investors in businesses that are too risky for institutional investors or banks.

Venture capital is not suitable for many entrepreneurs. Venture capitalists are very selective in deciding what to invest in. As a rule of thumb, a fund invests only in about one in four hundred opportunities presented to it. They are most interested in ventures with high growth potential, as only such opportunities are likely to be capable of providing the financial returns and successful exit event within the required timeframe that venture capitalists expect. Because of such expectations, most venture funding goes into companies in the fast-growing technology, life sciences or biotechnology fields.

There are various stages of investment which may take place in a company's life:

- **early stage** - investment in companies for product development and initial marketing, manufacturing and sales activities
- **seed stage** – investment in companies which have not yet fully established commercial operations, and may also involve continued research and product development
- **first stage** – usually the first round of financing following a company's start-up phase that involves an institutional VC fund. The round is usually a step-up in valuation for companies whose products are either in development or commercially available
- **second stage** - working capital for the initial expansion of a company which is producing and shipping and has growing accounts receivable and inventories. Although the company has clearly made progress, it may not yet be showing a profit
- **third stage** - funds provided for the major growth expansion of a company whose sales volume is increasing and which is breaking even or profitable. These funds are utilised for further expansion, marketing, and working capital or development of an improved product
- **later stage** - financing for the expansion of a company which is producing, shipping and increasing its sales volume
- **management buy-out** – the sale of the company to a management team backed by institutional investors[1]
- **initial public offering (*IPO*)** – the listing of a company's shares on a stock exchange and the raising of capital through the issue of shares to the public.

1 See the Swaab Introduction to Management Buy-outs

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Venture capital is a term that can be used to describe any of these investments up to later stage, although it is more usually associated with seed and first stage investments.

Early stage investments are mostly made by ***angel investors*** (wealthy individuals) and later stage investments and management buy-outs by private equity funds.[2]

Methods of start-up finance

When you start a new business, you need money to get it off the ground. You need the money to rent or purchase space for the business, furniture and equipment and pay for supplies. You also need money to pay employees. There are several places where you can get the money that a new business needs:

- **Personal savings** - you can fund the business yourself from savings or by getting a second mortgage on your home.
- **Bootstrapping** - in some simple businesses, you can ***bootstrap*** the business. That means that, with a very small investment, you get the business going and then use the profits from each sale to grow the business. This approach works well in the service industry where start-up expenses are sometimes low and you do not need employees initially.
- **Bank loan** - you can borrow money from a bank.
- **Angel investors** – as a rule, angel investors invest in opportunities that interest them personally and provide a financial return. Typically they invest in industries where they have some direct experience. Angel investors can often make fast investment decisions. However, although they are often looking for lower rates of return than venture capital firms, they still want to see a decent profit, and they may have limited resources so they cannot generally provide larger second and third round financing.

All of these methods have limitations unless you are already a wealthy individual. Venture capital provides an alternative source of finance and can help businesses with big start-up expenses or businesses that want to grow very quickly.

How venture capital firms are structured

You often hear about venture capitalists funding ***Dot Com*** (Internet) companies, but they fund all sorts of other businesses as well.

The classic approach is for a venture capital firm to open a ***fund***. A fund is a pool of money that the VC firm will invest. The firm gathers money from wealthy individuals, companies, pension funds and other institutions that have money they wish to invest. The firm will raise a fixed amount of money in the fund, for example, $20 million.

The VC firm will then invest the fund in a number of companies. Each firm and fund has an individual ***investment profile***. For example, a fund might invest in biotech start-ups. Or the fund might invest in technology companies seeking their second round of financing. Or the fund might try a mix of companies that are all preparing for an IPO[3] on a stock exchange in the next six months. The profile the fund chooses has certain risks and rewards that the investors know about when they invest their money.

Typically the VC firm will invest the entire fund and then anticipate that all of the investments it made will ***liquidate***[4] in 3 to 7 years. This means that the VC firm expects each of the companies it invested in to either do an IPO or to be purchased by another company[5]. In either case, the cash that flows in from the sale of shares to the public or from a buyer lets the VC firm cash out and place the proceeds back into the fund. When the whole process is done, the goal is to have made more money than the amount originally raised. The fund is then distributed back to the investors based on the amount each one originally contributed.

Some of the companies in which a VC fund invests will fail. Some will not really go anywhere. But some will go public. When a company goes public, it is often worth hundreds of millions of dollars. So the VC fund makes a very good return. For one $5 million investment, the fund might receive back $25 million over a 5 year period. So the VC fund is playing the law of averages, hoping that the big wins (the companies that make it and go public) overshadow the failures and provide a great return on the $20 million originally collected by the fund. The skill of the VC firm in picking its investments, managing those investments and timing those investments is a big factor in the fund's return.

Investors are typically looking for something like a 20% per year return on investment for the fund.

2 See the Swaab Practical Guide to Private Equity Funding

3 IPO means initial public offering and is also known as a **float** or **going public**
4 Liquidate means to be sold or to go public
5 Often by way of a **trade sale** to a company expanding its operations

How venture capital firms make investments

A company needing money to grow may apply to a venture capital firm to invest in the company. The founders of the company create a ***business plan***[6] to show what they plan to do and what they think will happen to the company over time (how fast it will grow, how much money it will make). The VCs look at the plan, and if they like what they see they invest money in the company. The first round of money is called a ***seed round***. Over time a company will typically receive 3 or 4 rounds of funding before going public or being acquired.

In return for the money it receives, the company gives the VCs shares in the company as well as some control over the decisions the company makes. The company might give the VC firm a seat on its board of directors. The company might agree not to spend more than a certain amount of money without the VC's approval. The VCs might also need to approve certain transactions or the people who are hired[7].

Typically a VC firm will make staged investments in a company. These may be dependent on certain financial milestones being achieved by the company, and are designed to protect the VC firm's interests and ensure they do not throw good money after bad.

In many cases, a VC firm offers more than just money. For example, it might have good contacts in the industry or it might have a lot of experience it can provide to the company by having a seat on the board.

One big negotiating point that is discussed when a VC invests money in a company is the amount of ***equity***[8] that the VC firm should get in return for the money it invests. This issue is resolved by valuing the company. The VC firm and the company have to agree how much the company is worth. This is the ***pre-money valuation*** of the company. Then the VC firm invests the money and this creates a ***post-money valuation***. The percentage increase in the value determines how much equity the VC firm receives. A VC firm might typically receive anywhere from 10% to 50% of the company in return for its investment, although it can be more or less than this. The original shareholders are ***diluted*** (reduced in percentage shareholding) in the process. The original shareholders own 100% of the company prior to the VC's investment. If the VC firm gets 50% of the company, then the original shareholders are diluted down to 50%.

What venture capital firms look for

Venture capitalists are higher risk investors and in accepting these higher risks, they desire a higher return on their investment. The venture capitalist manages the risk/reward ratio by only investing in businesses that fit their investment criteria and after having completed extensive ***due diligence***.

Venture capitalists have different approaches to investment, which may relate to the location of the business, the size of the investment, the stage of the company, the industry specialisation, the structure of the investment, the financial state of the company and the amount of involvement of the venture capitalists in the company's activities.

You should not be discouraged if one venture capitalist does not wish to proceed with an investment in your company. The rejection may not be a reflection of the quality of the business, but rather a matter of the business not fitting with the venture capitalist's particular investment criteria.

A venture capitalist typically seeks:

- superior businesses - venture capitalists generally look for companies with superior products or services targeted at fast-growing or untapped markets with a defensible strategic position
- quality and depth of management - venture capitalists must be confident that the business has the quality and depth in the management team to achieve its aspirations. Venture capitalists rarely seek managerial control, but sometimes they will assist the founders to identify and hire new managers. They want to add value to the investment where they have particular skills including fundraising, mergers and acquisitions, international marketing and networks. The venture capitalist will want to ensure that the company has the willingness to adopt modern corporate governance standards, such as non-executive directors, including a representative of the venture capitalist
- appropriate investment structure - as well as the requirement of being an attractive business opportunity, the venture capitalist will also be seeking to structure a satisfactory deal to produce the anticipated financial returns to investors. Venture capitalists are put off by complex corporate structures without a clear ownership base and where personal and business assets are merged
- exit plan - venture capitalists look for clear exit routes for their investment such as public listing or a third-party acquisition of the company.

6 See page 3 of the Swaab Practical Guide to Private Equity Funding for guidance on the preparation of business plans
7 See the table on page 3 of the Swaab Practical Guide to Raising Money for Companies for more information on rights given to investors
8 Equity means shares in the company

The investment process

INITIAL REVIEW

The investment process begins with the venture capitalist conducting an initial review of the proposal to determine if it fits with the firm's investment criteria. If so, a meeting will be arranged with the entrepreneur / management team to discuss the business plan.

PRELIMINARY SCREENING

The initial meeting provides an opportunity for the venture capitalist to meet the entrepreneur and key members of the management team to review the business plan and conduct initial due diligence on the project. It is an important time for the management team to demonstrate their understanding of their business and ability to achieve the strategies outlined in the plan. The venture capitalist will look carefully at the team's skills and backgrounds.

NEGOTIATING INVESTMENT

This involves an agreement between the venture capitalist and management of the main terms for the investment (referred to as the **terms sheet** or **memorandum of understanding** or **heads of agreement**).

DUE DILIGENCE[9]

The venture capitalist will then study the viability of the market to estimate its potential. Often they use market forecasts that have been independently prepared by industry experts who specialise in estimating the size and growth rates of markets and market segments.

The venture capitalist also studies the industry carefully to obtain information about competitors, entry barriers, and the potential to exploit substantial niches, product life cycles, distribution channels and possible export potential. The due diligence may also involve reports from accountants, lawyers and other consultants.

The amount of due diligence will, to an extent, depend on the amount of money being invested by the VC fund.

APPROVALS AND INVESTMENT COMPLETED

Final terms can then be negotiated and an investment proposal submitted to the board of directors. If approved, legal documents are prepared.

A shareholders' agreement is usually prepared containing the rights and obligations of each party. This could include, for example, veto rights by the investor on loans to executives, acquisition or sale of assets, and warranties relating to the accuracy of information provided to the VC fund.

The investment process can take up to 3 months, and sometimes longer. It is important, therefore, not to expect a speedy response. It is advisable to plan the business financial needs early on to allow appropriate time to secure the required funding.

Pros and cons of venture capital funding

ADVANTAGES FOR A COMPANY

- Faster growth
- Unsecured (non-recourse) finance
- Strengthens financial position
- May assist with obtaining other forms of finance (for example from a bank)
- Funding committed until exit (unlike bank loan)
- Management and relationship advice
- Adds credibility for the business

DISADVANTAGES FOR A COMPANY

- More complex accounting and reporting
- Investor veto rights over certain specified matters
- Accountability to investor
- Investor board involvement
- May be restrictive covenants for key employees (restraints)
- Warranties may have to be given by managers
- Investor is exit driven and is under pressure from its own investors to make a high return from the investment in the company.

9 See also page 3 of the **Swaab Practical Guide to Buying and Selling a Business** for more information on due diligence

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CONTACT US

The corporate team at Swaab Attorneys is committed to working with companies to help them meet their ambitions. If we can help you with any of the issues raised in this Guide, please contact Alistair Jaque. We would be very pleased to discuss any issues with you.

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This Guide is only intended to give an overview of the issues involved. It is not intended to be fully comprehensive or to be a substitute for legal advice.

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