

Inside the mind of a Venture Capitalist: Getting Your Start-Up Noticed by VCs

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After exhausting all fundraising opportunities for your start-up company from family friends and fools (affectionately known as the three Fs), you've come to the realization that it is time to bring in a venture partner to help grow your business. Unfortunately you're 10 years too late to take advantage of the money spigot that was the late 1990s and early 2000s. In today's environment, investors are much more thoughtful and so too should your strategy at attracting investment capital. Here is some useful insight into the venture capital fund raising process and how you can play to the VC's perspective as you try to negotiate your business to life.

Is Now the Time?

Seeking to add a venture partner is a significant event in the evolution of your business. Some important issues to confront at this stage in your company's growth include:

1. Raising capital is one of the most unpleasant tasks an entrepreneur will ever have to handle;
2. The typical VC firm only invests in 1 out of every 500 business plans it reviews;
3. As soon as you accept money from an investor, you become beholden to them.

With this in mind, it's wise to ensure you are seeking VC capital only when it is absolutely necessary. Ask yourself if you have truly exhausted all the ways to generate cash flow before you start to raise money. In a nutshell, the successful cash-strapped entrepreneur designs a transitional business model for launch, which can be described as "Heads I win; tails I lose very little." Once your concept has some degree of traction, then you can choose to talk to venture capitalists from a bargaining position of strength.

Do I even qualify?

Venture capitalists are continuously presented with business plans vying for their investment dollars. Here are some of the most important issues VC firms consider when they examine an opportunity:

1. **Financials** – Your Company's historical figures need to be accurate and reliable. In addition, VC firms will require up to date financials no less than 2 months old, so ensure you can produce interim statements and projections that can be explained in detail.
2. **Large positive returns** – If your *realistic and plausible* projections do not produce an IRR of at least 25% per year, you can expect to have a very difficult time raising money from a professional VC firm. Keep this in mind when you think about the initial value of your company because the higher the valuation, the harder it will be for the VC firm to earn the returns they promised to their investors.

3. **Management, Management, Management** – In real estate it's all about location, location, location. In the VC world it's all about management, management, management. This means that the entrepreneurial team must possess qualities which include honesty and integrity, relevant experience, measureable achievements, a high level of energy and strong motivation to build substantial corporate profits. Most VC firms agree that having a strong management team in place is the most important attribute to a successful investment.
4. **Unique advantage** – To attract VC funds, the business has to have something special whether it is a unique product, a patent, a special process or a two-year lead time on the competition. However, be sure that your special attribute is evolutionary and not revolutionary since changing the way people live on earth may take more time than the typical 5 to 7 year VC investment term.
5. **Identify the market opportunity** – A good entrepreneur starts with a vision of what the marketplace needs and wants and quantifies the size of the market potential. VC firms are less likely to invest in a solution to a problem or market that hasn't yet been identified.
6. **Exit Strategy** – VC firms usually have a 5 to 7 year time horizon for their investment. Make sure your pitch to a VC includes some discussion of when and how the VC firm can exit their investment.

Negotiation & Terms

A typical VC investment will outline the following terms and issues:

- Valuation of your company on a fully diluted basis – Often the biggest negotiation issue
- Type of ownership issued to the VC – Usually Cumulative Convertible Preferred shares with liquidity preference and put provisions
- Control ownership position – Most VC firms prefer this as opposed to a minority position
- Voting privileges/Board seat representation
- Rights of first refusal in favor of the VC firm
- Co-sale rights – VC shares must be sold with founders'
- Registration rights to preferred shareholders if the company goes public
- Vesting restrictions of founders' stock – This helps lock-in management for a period of time
- Anti-dilution provisions – This helps to preserve the value of their investment in the event of subsequent financing rounds
- Target Exit terms – Usually between 5 to 7 years with a minimum of 25% annual IRR
- Management Compensation terms

It comes as no surprise that VC firms are out to make the best deal for themselves and maximize protection of their investment in the pursuit of sizeable returns. Expect the process to take between 6 and 12 months just to find a VC that takes an interest in your company. This is a long, arduous period that often leaves your company cash-strapped which can put the VC in an even more advantageous negotiating position. To ensure you can negotiate in a position of strength, make sure to have a good corporate venture lawyer to help you focus on the terms that matter to you.

Finally, always remember that this is a partnership that may last several financing rounds for a long time in the future. Any successful partnership starts with a mutual understanding of the roles and benefits to be gained by all parties.