Fundamentals of the Venture Capital Process

There are a number of myths/truths about the venture capital industry and the process of securing investment from a venture capitalist (VC) that are important to understand.

1. It's a numbers game.

Since a VC has to process a very large number of new prospects, sometimes thousands each year, his highest priority is his own time management. This means that his work is mostly focused on eliminating 99% to 99.8% of the opportunities he is presented – as quickly as he can. The game becomes one of looking for reasons NOT to invest. Due diligence proceeds only when a VC feels strongly that an investment might make sense, so is usually a late step in the process.

Don't

Assume anything from a VC beyond normal, business courtesy. Waste anyone's time.

Do

Make your approach and presentation as friendly and easy-to-understand as possible. Even very technically sophisticated VCs want to start with a quick appreciation of why you believe your company deserves funding => ROI, return on investment to his investors. Save the technology details for responding to questions. Show just enough to demonstrate uniqueness and credibility.

Get to the point (unique value proposition) as quickly as possible – A successful "elevator pitch" must describe the company's value clearly, in no more than 45 seconds. A typical VC's attention span is less than 2 minutes! (assuming you get his attention at the outset).

2. Risk/Reward profile

Many entrepreneurs believe that VCs like to take big risks in making their investments. On looking at a VC's failed investments, you would certainly feel that way. When you look at the successful investments, however, quite a different perspective may result. Most VC investors are actually very risk-averse, which makes sense when you perceive the environment to be full of uncertainty and unknown factors. At the 50,000 foot overview level, the major categories of risk are: people (management, investors); technology (products), market opportunities(emerging or established), stage of growth (includes financing history), valuation. When a VC is introduced to a new investment opportunity, he mentally runs down this short checklist to see how the opportunity can be described in these terms.

Copyright 2001 Po Chi Wu

Don't

Emphasize how conservative your projections are.
Underestimate or downplay any risks

Do

Support your aggressive projections with credible plans for execution
Present an honest, realistic, and complete assessment of challenges

3. It's about the people.

Most venture capitalists today understand that they really invest in people, in the company management, directors, investors, partners, etc. Their comfort level increases proportionately to their familiarity with the people, directly or indirectly, as by reputation. There are venture firms that would probably jump at any opportunity to invest in a company backed by top tier firms like Kleiner Perkins and would do so with a minimum of due diligence. Similarly, there are people, like Mark Andreessen, who will attract investors like flies to honey. Historically, venture firms' first preference is to invest in companies run by people they have backed before, especially in successful companies. The next level of preference is to invest alongside the best VC firms. If a major, top-tier firm is not included in the investor list, a VC will invest in companies that are well-financed, i.e., show the potential for being able to raise more money from its existing investors, if desperate times come around.

Often, the biggest hurdle is just getting in the door of a reputable VC firm. Many VCs will not even look at opportunities that are not introduced to them by their friends and colleagues. Of the universe of start-ups, venture capital funding is available to less than 1% of these companies. However, when more than $40 billion a year are invested, thousands of new companies are created and supported by venture firms. These companies will continue to have an advantage in future fund-raising efforts, as compared to non-VC backed companies.

Don't

Compromise on the quality of your people.

Do

Hire the best people you can find (and afford – but don't let "affordability" be a self-imposed limitation). Network constantly, to establish a personal and corporate presence in Silicon Valley. Develop relationships through your corporate legal counsel, accounting firm, bank, investors, advisors, and all employees. You never know where the most useful introductions will come from.

Copyright 2001 Po Chi Wu

This "people" issue can be a perception challenge for a company whose people are senior, but who may not be very well known in Silicon Valley. In future hiring, be sensitive to this aspect. Consider forming advisory groups, whether for technology, marketing, or some other purpose. Figure out how to attract and involve people who bring the kind of credibility and personal relationships that can help the company.

4. The potential market opportunity must be big (billions of dollars).

This is actually a complicated issue, with several aspects that need to worked through. The ideal proposed market for the products (or service) should be already identified, rapidly growing (more than 25% per year), and not dominated by any other companies, large or small. Your products should present a significant barrier to entry by future would-be competitors; often this is accomplished by proprietary, patented technology. A more subtle point is that the company's management and growth strategies are strong enough to support the proposed plan.

Silicon Valley VCs want to back companies they believe can and will dominate market niches. Such a result is the most obvious, incontrovertible evidence of superior technology, superior management and superior strategy. Domination = winning the game, the game defined as being well positioned for a "liquidity event" = IPO or acquisition at an attractive valuation.

Don't

Simply present gross numbers for Total Available Market, with an expectation of gaining 1% market share.

Do

Be as specific and as clear about a particular market segment as possible. Include a thorough discussion of why your products will dominate over competitive products. What a VC is looking for is the understanding of the market dynamics of the particular niche, the knowledge of what competitors are doing or might be doing in the future, and the strategy of the company's product and market development strategies.

For every company, this market issue is critical and one of the most important ones to address. In the first couple of meetings, a VC is testing for general credibility – how believable is the plan, how good is the technology, how much market share is actually possible, how strong is the management, etc. The reason is that if any of the assessments of these issues is negative, it will be easy for the VC to decline to invest. Be prepared with due diligence materials that support your view of the market opportunity – references, market studies, customer indications, media publications, etc.

5. Listen for what is unsaid.

Copyright 2001 Po Chi Wu

Unfortunately, VCs, at least the smart ones, have learned to be nasty and suspicious of most people who come looking for funding. The more polite ones will not show this general distrust of the human race, but their questions will reveal their need to be careful and even skeptical. At the same time, VCs must be among the most optimistic people on the planet, whether they openly admit this fact or not. How else could they justify their investment strategies? Aggressive VCs challenge an entrepreneur's assertions directly. A more subtle VC approach is to listen for what is left unsaid – the implication being that what is unsaid may be more important, and potentially more damaging to the business proposal.

Don't

Be overconfident about or exaggerate the superiority of your technology or your business strategy.

Do

Take a layered approach to revealing information. Be brutally honest with yourself about whatever information you share. Emphasize strengths, by all means, and stress ways to overcome weaknesses. Find the delicate balance between too little and too much information at any given time. Most VCs will not understand your product or market as well as you do, so they will need some time to absorb how your product and technology can affect the market.

Encourage the VCs to ask questions. Presentations can be designed to lead the audience to want to ask certain questions – for which you have prepared convincing responses. Credibility is everything, and the VCs appreciate a strong presentation that moves along at "the right pace". Showmanship counts.

6. Everything is negotiable.

To some VCs, every interaction is like a move in a chess game, an element of strategy in a game of negotiation. In principle, an entrepreneur should not be afraid to negotiate, to "push back", especially on any "negative comments" offered by a VC. While VCs do not typically lie or try to manipulate entrepreneurs, they are certainly willing to test for knowledge, commitment, or simply confidence. An entrepreneur who automatically and consistently defers to a VC may soon find himself in a very unappealing negotiating position. Treat the VC with respect, certainly, again, like a valued customer, but not to extent of being untrue to yourself. At the end of the day, when the deal is done, yes, the customer is "king", but that does not mean you have to demean yourself in the process. Self-respect is one of the keys to gaining respect from others.

Don't

Be overeager to please or defer to whatever a VC says. Sometimes, they are inconsistent (being human) or just testing you. You want, above all else, to earn their respect. Being afraid to stand up for yourself and your company won't help.

Do

Listen carefully, with more than just your ears, and respond thoughtfully, to address concerns that may have been left unspoken. Show your respect for all that your team has accomplished, including your own contributions. Show your sense of the value that you believe you have, without appearing unrealistic. Enjoy the negotiation – it's a learning experience as well. Negotiating with a VC is going to be a lot easier than with a strategic partner. Test the VC's negotiating skills. You may need his support in later negotiations with other investors or partners.

7. VCs want to control their portfolio companies.

VCs typically want minority ownership, between 10 and 20% of a company's stock, and often will request a seat on the board of directors if they are the lead investor or a large investor. They usually do not want majority control, because that would mean taking on full responsibility for managing the company. A VC wants to know the truth about what is going on, and wants to be able to protect his investment, should circumstances require more active involvement or guidance. A smart VC will not invest in a company if he feels that he knows more than the management team does about their business opportunity. That makes no sense at all. The management should have much deeper and more complete information than the VC.

Don't

Be paranoid about control. The reality is that the management needs to develop a strong, friendly relationship with all the directors, one based on mutual respect. Once a company has outside investors and directors, everyone's voice counts, although not necessarily with equal weight. There will certainly be differences of opinion, which need to be aired and understood.

Do

Build consensus by keeping everyone focussed on the common goals needed for success. Make sure these are stated clearly during the evaluation phase, pre-investment, and agreed-upon. This is one of the most important tasks of a CEO and/or Chairman, to set a tone and focus for the company, including the investors. Interests, energies and commitments must be aligned. In that context, "control" has a different meaning.

8. VCs assess a company's current valuation by their perception of future value at the next financing.

Company valuation is one of the subjects of greatest contention between companies and prospective investors. The reality of the situation is that the valuation of a privately-held, pre-public, company (especially with little or no revenues), is almost completely determined by the marketplace, i.e., whatever an investor or acquiror is willing to assign or pay for. While there are "rules of thumb" and comparisons can be made to competitive or similar companies, these numbers are just guidelines. The price of the stock is very much a negotiated quantity.

Don't

Be stubborn or overly proud about a preconceived notion of valuation.

Do

Prepare as much information to justify whatever valuation you have in mind, but be flexible and open-minded. There are many ways to interpret valuation, in terms of time-adjusted risk, liquidity, percentage of a larger market opportunity, even in terms of personal compensation to the entrepreneur and the management team. Let the VC make the first move in setting a valuation. Let him show how he is thinking about the issue, what factors are most important to him. Then, you will know how to focus your responses.

9. Not all VCs are created equal.

A misfortune that occurs, regrettably too often, is a mismatch, a fundamental miscommunication about values, between a company and its venture investors. An unhappy investor is one of the tiring liabilities a management has to deal with. A board of directors that is not aligned in purpose and intent will, sooner or later, experience such dissent that management will find itself embroiled in managing difficult personalities to the extent that company business can suffer from neglect.

Don't

Be desperate or greedy to accept whatever investors and money appears to be available.

Do

Research the VC carefully and as thoroughly as possible. Communicate clearly and honestly about any concerns. Establish a framework of mutual respect.

10. BE POSITIVE – Focus on what you <u>can</u> do. A focus on negative aspects drains you.

Copyright 2001 Po Chi Wu

How to Raise Money from Venture Firms

There are books written on this subject, as well as numerous Web sites that are full of advice on this subject. If you have the time, it is certainly worthwhile to peruse some of these materials. One of the classic publications is "Pratt's Guide to Venture Capital", which includes some chapters on preparing for the VC interview as well as an extensive list of venture firms, with some detail on their areas of investment.

Briefly, the steps are:

1. **Find people to introduce your company to VC firms**

   Directories of VC firms
   Paid consultants, brokers, "middlemen"
   Friends and acquaintances
   Company employees
   Company advisors (legal, accounting, banking)
   Directors, investors
   Senior management
   (in order from least to most effective sources of introductions)

2. **Prepare the appropriate materials**

   Business plan
   PowerPoint presentation
   Executive Summary
   E-mail/cover letter intro

3. **Make initial contacts**

   Phone
   E-mail
   Fax
   Mail
   Do some research to learn what specific areas each VC is interested in. To whatever extent possible, choose to contact VCs who appear to be "value-added investors". The biggest initial hurdle is just getting an appointment, an opportunity to present your case.

4. **Make in-person presentations – think <u>dialogue</u>, more than monologue**

   PowerPoint presentation/hard copies for attendees
   Detailed responses to anticipated questions (presentation slides, written materials)
   Do some research to learn what specific companies each attendee is involved with
   Do ask questions of the VCs to elicit information they have that may be useful
   – market data, names of competing firms, possible strategic partners, etc.
   Ask for next steps to take in the evaluation process

Copyright 2001 Po Chi Wu

5. **Suggest follow-up meetings** at your company, to meet other staff, see demos of future products, something that was not discussed in detail at the first presentation (often at the VC's office).

6. **Follow-up with additional materials** as requested or with additional information that you think enlarges on certain topics that were covered in the presentation. Keep calling periodically to check in on the VC's progress. At some point, the VC will either decline or stop accepting calls from you, which is one of the ways he will indicate lack of interest.

7. When using "middlemen", consultants or brokers, understand that their highest value is usually realized when an appointment for a presentation is set. They can help with the presentation, but a VC typically prefers to deal with the principals, i.e., company management. After all, those are the people he wants to be impressed with. They are the ones who will execute the plan. They had better be able to articulate that plan convincingly. VCs absolutely prefer a slightly rough, "homemade" business plan prepared by the entrepreneur himself, than a slick, "professional plan" prepared by a paid consultant. The VC is looking for "integrity" in the opportunity, that the entrepreneur who proposes a plan truly has the ability to execute it. An experienced VC can sense a "prepared plan" very quickly and will be inclined to dismiss such proposals.

   PowerPoint or other presentations that are "professionally prepared" do tend to be clearer and more persuasive than "homemade" ones. Here, the "integrity issue" is less important, since the VC understands that this is a marketing piece, designed to attract attention and deliver a quick, persuasive message. Of course, management still has to deliver this message as convincingly as possible. If the VC senses that the entrepreneur is "acting", working hard to deliver a performance according to a script written by others, that VC is not likely to invest.

8. The order in which information is presented can be important, as well as the quantity at each step. First step – get the VC's attention with a crisp, simple statement of why your company's product and technology have unique value, i.e., why you deserve consideration as an investment opportunity. Second step – find out how the VC processes opportunities – i.e., is he more concerned with technological superiority, size of market, competitors, management, etc.? Let his interests, priorities, and concerns guide you - understand his viewpoint and the way he wants to work. Understand his past failures as well as successes.

   Put another way, give the VC enough to chew on, but not so much that he holds up his hands in an attempt to avoid being inundated with too much information. If a VC is interested, he will naturally ask for more information or more meetings.

9. If middlemen or brokers are involved, company management should insist on maintaining direct contacts and relationships with the VCs. Don't expect the

Copyright 2001 Po Chi Wu

middlemen or brokers to follow-up, provide additional information, make further appointments, etc. You can, certainly, ask them to do so, but company management should dictate and guide the process. The direct relationship is extremely important. The VC is also evaluating company management by the way they manage the process of fund-raising, the level of professionalism, the commitment, the responsiveness, etc.

Treat the VC contact as you would your most valuable customer. This is the most important sale of your company's life – literally. Get to know him, cultivate a friendly relationship. Understand his viewpoint, his prejudices, his preferences. Take a long-term view to the process. VCs are important people to know. Even if they decline this investment opportunity, there will always be opportunities in the future. Next time, you won't be a complete stranger!

10. One of the most valuable aspects of the process is understanding the real reasons behind a VC's lack of interest, or his interest. You can learn a great deal about how you need to improve – your strategies, your product/technology, your communication skills, or some other aspect of your company. The challenge is that few VCs are willing to invest the time to give you that kind of feedback. If the introduction to the VC was made through another person, perhaps that person can help get you that feedback.

11. Track the process on a spreadsheet and manage accordingly. The more organized your campaign, the better your chances of getting valuable results, with a minimum of time wasted and uncertainty.

12. Be as thoroughly prepared as possible and polish your communications and interpersonal skills. The adage: "You never get a second chance to make a first impression" is particularly applicable to interactions with venture capitalists. These are people who make their living, whose reputations depend on the perception of their ability to make good (profitable) judgments. The first impression, the first contact, is extremely important.

Copyright 2001 Po Chi Wu