Chapter 2
Raising capital

Introduction

Since 1990 the venture capital (VC)/private equity (PE) market has come of age, often described as 'titans of industry'. The main players have become part of corporate history; Kohlberg Kravis Roberts (KKR) hit the headlines with the takeover of RJR Nabisco and when Sequoia invested in Google and they turned $12.5m in to $4 billion over eight years.

These examples highlight that the returns for venture capitalists can be high. But they need to be, as not every investment is profitable. The big successes need to pay for the failures and it is a high-risk industry. This chapter looks to explain what venture capital is, how it works and what you need to do to attract it.

1. What is venture capital?

Venture capital, private equity and development capital are all names for money invested in a company by a financial backer – usually an institution. It is not bank debt. It is entirely risk money, just like the money you put in to 'start up' or when you buy the company. A comparison between the venture capital and debt options (i.e. from a bank) can be illustrated in the following way:

Venture capital	Debt
Committed until shareholder(s) ‘exit’ the company	Term-based or often repayable on demand
‘Returns’ based on company growth and success	Shared costs and repayments due whatever the results
Investors work alongside the shareholders	Lenders generally have first option on any company assets
Investors work with you through any difficulties	Lenders prioritise on either loan or asset security over and above the success of the company

Venture capital usually involves selling part ownership of the company to help it grow faster. If you are not prepared to consider taking on an outside investor to grow your company then this is not for you. Nor is it an alternative to bank debt, as by selling shares you are bringing in an investment partner who will want to see growth.

As with all things in life, there are a number of different facets to the venture capital and private equity market. In this chapter we will consider the venture capital side. Venture capital, in its simplest form, is capital (equity) invested into your company for one of three reasons:

1. Seed capital – to get you started
2. Development capital – to push you forward
3. Growth capital – to expand the company

Raising finance from this source has become a popular route, especially for smaller organisations. This should be of interest to those running smaller companies (or those wishing to start a company) who have identified the requirement to raise external investment to help fund the process.

2. Be clear why funding is required

Let's start by trying to put you off venture capital. A VC in the form of a Private Equity House will want high-growth, high-return companies, run by strong management in sectors that are or will grow faster than those around them. It will put significant performance targets on you; they will expect a Board of Directors position and depending on the investment agreement, have the option of dismissing you if you do not perform!

Don't waste your time chasing venture capital if all you want to do is maintain a lifestyle business. If you don't have ambitions for significant growth or if you need money to reduce bank exposure or fund past losses then think about if this option is what you really want.

VCs often look for high-growth companies that need significant amounts of cash. They want ones with big ambitions, who are willing to work with outsiders and who are prepared to share the spoils of a larger company when it is sold.

They usually have hundreds of business plans sent to them every year seeking investment as they are the 'next big thing'. Before even reading the plan, the investment director will look at the team behind the plan. As much as they invest in a company, they invest in the people behind it. We all know having an idea won't make you rich on its own; it is how well that idea is developed and executed.

3. Which VC to approach and how

Most VCs usually have a variety of investment criteria that they insist on in order to make an investment. Generally these will be:

- Phase of the investment – start-up, development or growth
- Size of the investment
- Being a specialist in a particular sector

A list of companies can be found online or from most countries' venture capital associations. In practice, most companies seek professional advice when approaching venture capitalists as well as experience and personal contacts. An experienced corporate finance adviser is essential to help you through the maze of different choices and the complexities of the challenges they pose.

Some of the large ones have web portals where you can send them your business plan – either by answering a few questions or submitting a full plan.

4. The business plan

Once the company is prepared and a potential investor has been identified, an attractive case needs to be presented to a VC. This will help to arouse interest and hopefully initiate a preliminary meeting. This is normally achieved by the preparation and distribution of a business plan (covered in Chapter 1, *Better business planning*).

Great care must be taken in preparing the document to achieve maximum impact.

There are plenty of guidelines on the subject of preparing a business plan but many companies seek advice and assistance in this area. Most importantly, the plan should be written by the management team and include a short, concise executive summary.

Keep the plan relatively brief by, for example, placing corporate literature etc in an appendix which can be referred to in the main body of text. Most investors want to know the following key points:

- The company's purpose
- The problem that it solves and how it solves it
- The size of the market and the competitors
- The business model – in particular, how you will take the idea to market, pricing, customer profile (including the life and value of the product/service)
- The team – and why they will be able to deliver the plan
- The financials – Profit and Loss (P&L) statements, Cash Flows, Balance Sheets
- What is being offered to a VC

Most of these will be easy to determine, although the most difficult to put together are the financials. Remember that when a VC looks at potential investments it goes for the team first and often the financials last. The reason is that they know that the right people in place with a very good idea will often produce the best results.

However, they want to see credible assumptions – for example, the cost of any future acquisition of a customer, the lifetime value and how these are delivered. They will also want a company to demonstrate a fundamental knowledge of the business side and how it operates. Many VCs will then 'remodel' the proposal to see how their investment will make a difference.

5. Be prepared to face emotive issues

The transition from a 100% owner-managed company to that of one in which a VC has even a minority stake will change the culture of an organisation. It may also raise emotive issues for an owner-manager. This can often involve admitting that as a business owner or major shareholder you will lose some control over the direction of the company. To a large extent, this is what you would expect if you look to raise capital and invite other shareholders into the company.

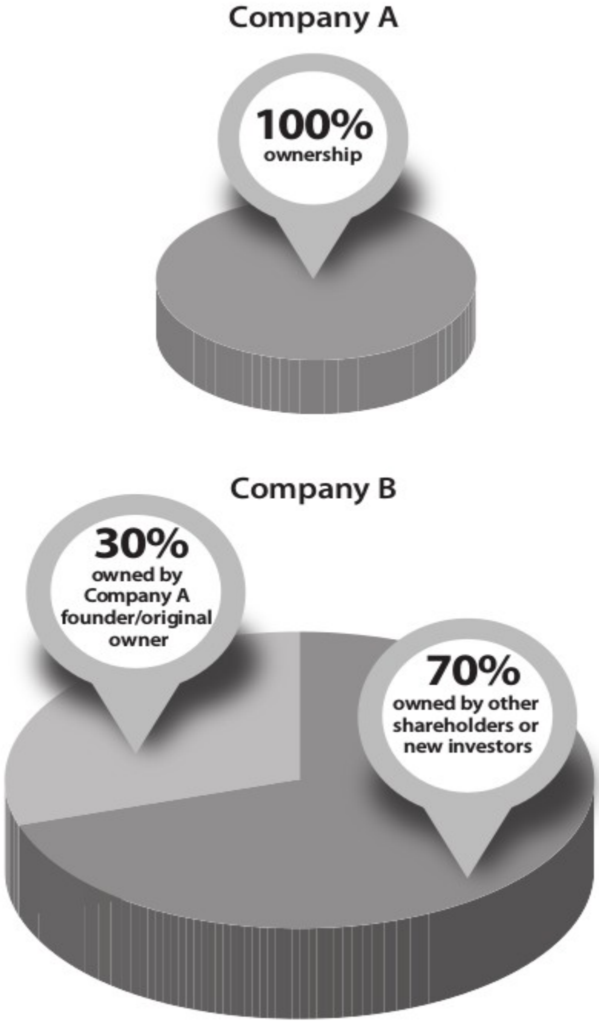
A question of 'letting go' of your old company can be hard for any business owner. But you need to ask yourself the following questions. Which would you rather have?

1. A 100% shareholding in a company with an annual turnover of £5 million (with total control)?

   or

2. A 30% shareholding in a company with an annual turnover of £50 million (with partial control but much more potential)?

Shareholder comparison



This is what your plan should show and you need to accept that a lower percentage of 'a large cake' is better than 100% of a much smaller one, i.e. a smaller percentage can often mean higher value.

Although a VC may bring valuable experience to a company, the provision of funding comes with certain rules and regulations. These are normally encapsulated in new Articles of Association for the company and a negotiated shareholders' agreement. They may cover areas such as dividend policy, capping of directors' salary levels, restriction of trading activities, borrowing facilities as well as other global financial controls. As part of the business planning process, you must be prepared to address these issues as and when they arise.

6. Prepare by 'grooming'

Before any VC will invest in a company, it will usually undertake a detailed review of the organisation from both a commercial and financial perspective. This process is called 'due diligence'. It may be performed by lawyers, accountants and consultants who usually have business experience in the relevant sector.

Of course not all companies who look for investment will be at the stage where they are ready for the potentially intrusive due diligence process. In order to facilitate this, you need to prepare yourself and your company. This will entail measures like ensuring that you have a suitable management structure in place.

There should be contracts of employment for the senior employees and all corporate and legal requirements need to be complied with. You should also have suitable accounting and financial controls in place, have a good balance sheet (i.e. don't have any non-business assets), and all taxation issues need to be clear and up to date. This is all part of the change process you will need to go through in order to attract an investor.

7. The investment process

Once a business plan has been distributed to selected VC and it has indicated a willingness to consider an investment, a number of meetings will probably be needed. At this point, further information may be requested and exchanged and a series of discussions and negotiations will take place. This allows a general familiarisation process for both parties and achieving mutual 'comfort' with your potential investor should not be underestimated in view of the possible future close relationship.

Following a successful period of negotiations, a VC will make an indicative investment offer (subject of course to due diligence, warranties etc). This will include a valuation of the company and the major terms of a proposed transaction. It will normally promote a further series of negotiations. It is preferable to identify more than one potential investor but there comes a time when they will want commitment and exclusivity. At this point you will need to decide who to proceed with.

When the broad principles of an agreement can be reached with the investor of your choice, you will be invited to sign a letter of intent which will include this period of exclusivity (usually six months).

At this stage it is usual to commit to bearing some or all of the costs of due diligence which is the next step. More negotiations may follow if any issues arise out of this process before a final valuation of the company and investment terms can be agreed. This is followed by the preparation and signing of legal agreements and warranties etc. Finally the money is transferred to you and the investor acquires a relevant proportion of the company based on the agreed valuation.

You should look to create your own investment process stages in the following way:

The investment process

Stage	Entrepreneur and Advisers/Corporate Finance	Venture Capitalist – Private Equity House
1. Formulation of the idea	• Appoint advisers • Prepare plan • Review viability and funding requirement	• No input at this stage
2. Approve Private Equity (PE) House	• Prepare target list of PE Houses • Circulate the plan	• Review business plan • Establish valuation parameters • Consider funding structure
3. Initial meetings	• Provide additional information • Prepare presentation	• Meet to discuss plan • Establish relationship • Provide outline terms
4. Due diligence	• Assist with process • Appoint lawyers and accountants	• Initiate due diligence • Liaise with advisers
5. Final negotiations and completion	• Stay calm and focused • Listen to advice • Negotiate final terms	• Prepare completion • Draw up documentation • Confirm final offer

This investment process could take anything from a few weeks to many months. For most companies, a suitable timeframe would be three to six months if all goes well. A typical period from the distribution of a business plan to achieving an investment would be more like six months. This, however, assumes that all the necessary grooming processes and preparation of a business plan have been satisfactorily completed beforehand. Taking these latter points into account, the lead-time to achieve a funding objective can be substantial and needs to be recognised at the outset.

Although difficult to assess, the longer-term considerations of achieving your preferred exit strategy should be considered and included in planning the overall timetable for a fundraising exercise. Once an agreement is reached, the hard work of making your plans a reality begins!

8. Exit

A VC's objective is to invest in companies which grow and which increase in value accordingly. Typically they will look to reinvest as the company grows and may well bring in others to invest alongside them. However, eventually they will look to sell their investment to realise a capital gain. This 'exit' may be achieved as a result of a trade sale to a competitor, a public flotation or the sale of their investment to a 'secondary' PE House who in turn may provide additional funds for further expansion.

It is important at the outset to be aware of your own aspirations in order to plan an exit strategy (both in terms of timing and valuation). You need to understand and agree in principle the VC's objectives, and proceed accordingly.

Don't make the mistake of thinking that this means that you have to exit, if you do not. It could be just a case of offering them a reasonable timeframe and method for them to exit, leaving you to continue to achieve your vision alone or with the other party. But if this is the case, make sure that both parties agree that this is possible so that you continue with the knowledge that you have the tools in place to be successful.

9. Other practical issues

There are a number of issues that you should be aware of when you are planning to raise venture capital:

- Don't always expect a non-disclosure agreement (NDA). A PE House is a professional organisation; they are unlikely to want to compete with you in your line of business. Some of the larger ones refuse to sign them. This should not necessarily scare you off but it is always advisable as part of the due diligence process to cover this off for your own protection.
- Even before signing a letter of intent, ask to see a draft shareholders' agreement and any proposed changes to the Articles of Association. Ensure you fully understand the terms of the investment, especially in the event of something going wrong.
- If there is to be an employee share option scheme, agree this in advance as this could affect the future balance of ownership and control of the company.
- Be prepared for an investment offer to be made as a combination of equity and preference shares with prescribed dividends attached. This could include loan stock repayable over a defined period and loan stock convertible to equity on exit etc. As a consequence, two offers may not always be directly comparable.
- Some investment offers may include a 'ratchet' clause which can increase an investor's shareholding if certain performance targets are not achieved.
- Ensure that you obtain appropriate legal and financial advice.

Finally, it is often worth reaching out to create relationships early on and by discussing your plans with a VC it can put you firmly in control.

Summary

Venture capital is not for everyone but for many it is the fuel that enables business owners to realise their dreams. There is risk involved as with any form of lending and it might appear intrusive to some in terms of a third party having some ownership of your company. There is also a question of a VC having a large amount of control and helping determine the future direction of the company.

However, this sector has a very good track record having helped to create thousands of multi-millionaires. With proper advice and structure, a VC can be the best partner a growing company can ever have.