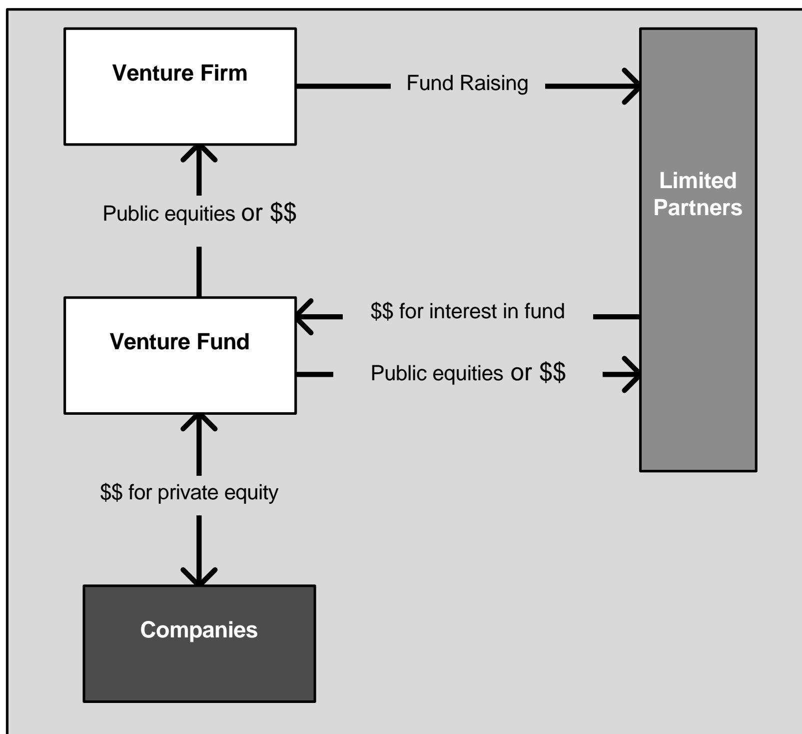
RAISING MONEY
SOME TIPS ON WORKING WITH VENTURE CAPITALISTS

You've got it! You've developed a product or business concept that should make you and your team rich. Now you want to raise venture money to get the company off the ground. As a first-time entrepreneur, you might find the process of raising venture capital both daunting and mystifying —and since only one in every 100 opportunities a venture capitalist reviews will actually be funded, you've got a right to be concerned. So, what's a poor founder to do? Well, here's one ex-entrepreneur-recently-turned-venture capitalist's response to some key questions entrepreneurs might be asking about the funding process and how to make your business interesting to the venture community.

How does venture capital work?
Venture firms are usually partnerships formed by one or more *venture capitalists (VCs).* The partners in the firm raises money to form a *venture fund.* The investors in the fund are called *limited partners* or "LPs", and include sources such as pension funds, private institutions (universities, charitable trusts), and wealthy individuals. The LPs invest this "risk capital" in order to receive above average returns (better than the stock market) on their money over a period of 10-12 years. The following diagram provides an overview of the venture process:



- *Venture capitalists (VCs) form a partnership or venture firm*
- *The firm then raises a fund to invest from Limited Partners (LPs)*
- *Venture firms invest money in companies in return for equity*
- *The company reaches "liquidity" with an IPO or acquisition. Public equity or proceeds from sale can then be returned to the LPs*
- *VCs make money by sharing in the profits of the funds, after capital is returned to the LPs*
- *Once a fund is invested, VCs raise another fund to invest, while continuing to manage the previous fund to liquidity*

What do venture capitalists care about?

Money! At the end of the day, all venture capitalists must care about making money for their Limited Partners. There is enormous pressure on venture funds to return far better than average returns to their LPs in return for the risk capital invested. VCs will only be interested in your business if it promises to make a lot of money, and reach liquidity within a 3-6 year period.

In addition to money, most VCs also care about creating value—seeing new markets and products developed, participating in the formation and growth of important companies, working with entrepreneurs to build new businesses, and supporting the growth of the economy—the ability to be involved with and influence the development of young companies is almost universally considered a privilege among venture investors in their more introspective moments.

What is "a lot" of money?

Hundreds of millions is a good place to start. Every venture investor has to plan for some companies to barely succeed and for some to (gulp!) fail. So, there must be some "big wins" to compensate for those deals that are mediocre and worse. To be really interesting, a company must have the potential to return twenty times or more the money invested at the liquidity event (i.e. IPO or acquisition) within a "reasonable" period of time, usually 3-6 years.

The minimum size opportunity most venture firms look to invest in can be characterized by a company generating $20M to $50M in revenues within four to six years, with pre-tax profits of 20% or more. Using five times revenues as an average market value metric, this company would be worth $100M to $250M in the public market within six years—an excellent outcome, but still not the really huge financial wins represented by the Suns, Ciscos and UUNets of the world. If you aren't starting out to build a company valued in this range, then you may not be a good candidate for venture money.

What do venture capitalists invest in?

Businesses. People. Markets. Venture capitalists ideally invest in great people focused on building businesses in big markets. However, VCs will sometimes invest in great people focusing on what may be a so-so market, or on a "B team" that is addressing a market with a lot of potential.

What are the characteristics of an interesting investment?

Each firm, and each partner in each firm, will have their own profile for "good" deals. As a rule of thumb, an interesting deal has three to four of the following qualities:

- Consists of one or more great people
  A great or "A" team contains people who are both uniquely suited to prosecute the proposed business and match the aggressive, risk-taking profile of an entrepreneur.

If the company is very early stage, an investor may bet on the ability of just one person to act as the founder and attract a team with the help of the investors.

- Targets a big (>$500M), rapidly developing market
  Big, fast-growing markets are good. They are forgiving. The momentum they provide allow companies to grow in spite of the inevitable mistakes in execution, organization, product or technology directions. Recent examples of big markets include the explosive network and communications segment and client-server customer care/sales force automation markets.

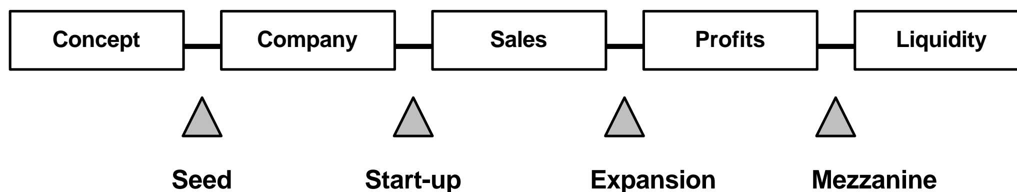
- Avoids being too early or late into the market
  Being too late is bad, because there is too much competition and you have to fight the market leaders (example: late ISPs). Being too early is bad, because it is expensive to educate the market in a missionary sales environment and the infrastructure necessary for success often isn't available (example: 1st generation workflow companies, ITV). Understanding the timing of the market is critical.

- Requires modest capital to demonstrate a feasible business exists (e.g. $1M-$5M)
  If a company needs $30 or $50M to get to the point where it reaches the market, most venture capitalists will shy away from the business as too risky (example: new semiconductor manufacturing companies are extremely hard to get financed)

- Possesses or can develop some form of sustainable competitive advantage
  Competitive advantage is difficult to develop and retain. Initially, most competitive advantage in start-ups comes from the "know-how" of the founders. It may also be based on proprietary and hard to replicate technology advantages, preferential relationships with partners or suppliers, or unique access to scarce resources.

- Describes a believable and attractive business model
  A business model is a description of how a firm is going to make money once the business is operating. Most start-ups do not have believable business models unless the business under consideration is highly analogous to an existing and proven business segment. For example, the early client-server business applications relied on a business model that closely resembled the models used for database applications; since the buyers of these applications were frequently customers of the database applications as well, this model worked.

What type of funding do you need?
Like other industries, the venture community is segmented. Many venture funds focus on a particular investing profile, including industry specialization (e.g. information technology, biotech, retail, etc.) and stage of company (e.g. seed, start-up, mezzanine, etc.) Other venture firms, particularly the very large or "mega-funds", maintain a balanced fund and invest across a diverse range of markets and stages. The diagram below helps identify company stages relative to the type of funding available.



To make sure you aren't wasting time approaching the wrong firms, you must realistically assess what type of venture financing you need. In particular, distinguishing between a seed stage company and a first-round start-up is often a bit tricky. While precise definitions for seed and first round do not exist, and most companies fall somewhere in between on one or more dimensions, the chart below offers some guidelines for determining what stage you map to best:

CHARACTERISTICS	SEED STAGE	FIRST ROUND START-UP
Management Team	Incomplete and/or first time in proposed roles. Often comprised of technical founders with little other management	Largely complete and/or comprised of individuals experienced in proposed roles. Well-qualified CEO on board or identified at time of funding
Product	Conceptual stage with core design/development in place, up to beta	Very close to shipping; ideally installed in beta sites or shipping to customers
Business Model	Undeveloped. Some anecdotal evidence or customer interviews, but lacking real-world proofs	Well-developed, with limited but real-world evidence to support conclusions (e.g. initial paying customers or partners)
Customers	No customers, but some potential buyers identified	Some customers using and/or paying for product or service
Revenue	Little to none. Revenue growth up to 18 mths off, but may have related revenues (e.g. consulting)	Up to several million. Real revenue growth is near-term, within 3-6 mths
Capital Structure	Less than $250K invested; usually no professional investors involved	Seed money in; may have private or professional investors beyond founders

Characteristics of Seed Start-up vs. First Round Start-up

How are venture firms structured?

Each venture firm is unique, however the common roles and responsibilities are as follows. *General Partners (GPs)* are the senior members of the firm, and normally share the responsibility of raising money from LPs and overseeing investment activities in companies. GPs are usually held personally libel for the firm and contribute significant personal capital to each fund raised. *Partners* or *Venture Partners* are also responsible for investing in companies, but are less senior and still earning their place as a GP. *Associates* are the junior members of the firm, and normally work with GPs and partners to identify new investment opportunities and perform diligence activities. Finally, most venture firms also rely on a staff of administrative and financial personnel to assist in managing the day-to-day operations of the firm.

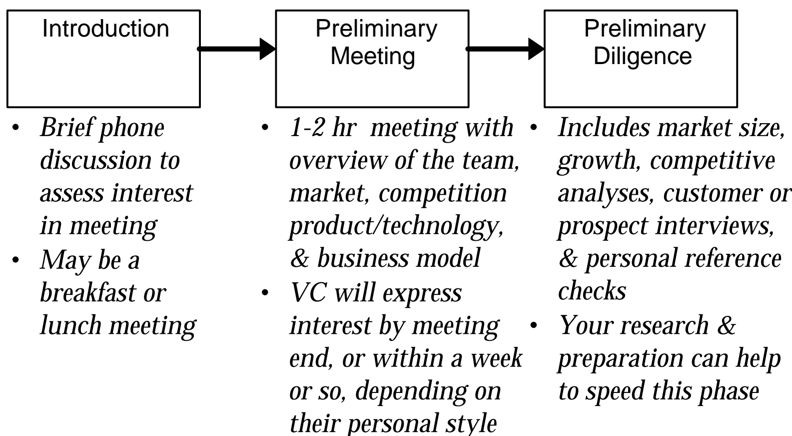
Who are venture capitalists?

Individuals. Some come from financial management backgrounds, others from technical or executive positions in industry. Most have seen a lot of different business ideas come and go, and recognize that investing is not a zero-sum game—so they can let any one deal pass by with great equanimity. Their job requires them to say "no" to entrepreneurs 99% of the time. Venture capitalists tend to be bright, busy people that put a premium on their time. Consequently, they are (1) impatient and (2) prone to quick evaluations.

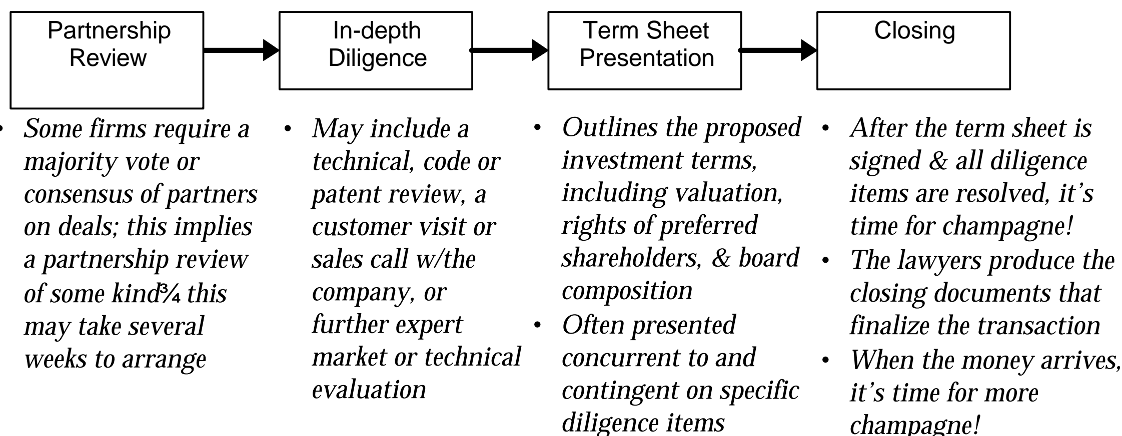
When dealing with VCs, be flexible and efficient in your communications. Develop a written executive summary that describes your business and team in 1-3 pages, and make sure that every word is to the point. Never forget that VCs are people that invest in other people. Therefore, the better the VC can relate to you as a person, the more likely you are to be given the opportunity to win their support. In meetings, follow the lead of the investor. Give them a chance to tell you what they want to hear from you and how they want to hear it. . Don't waste their time telling them what they already know. Remember that you are not the first entrepreneur that the VC has ever dealt with, and that they might know (or think they know!) quite a bit about your product area or market segment. Don't let your own anxieties regarding the meeting get in the way of your ability to pay attention to the nuances of the people in the room. Prepare your pitch your way, but allow the VC set the pace, structure or tone of the meeting if they so choose. Be ready for any kind of audience, including those that are passive, impersonal, joking, brusque, inquiring, combative, skeptical, chatty, apparently bored, uninterested and downright rude. No matter their style, use your communications talent to get the merits of your company and business model across.

What is the process for getting a venture investment?
The typical process more or less involves the following seven phases, as shown below, and can take anywhere from a month to six months or more.

Phase I: They might be interested…



Phase II: They're really serious…



What is the best way to approach a venture firm?
For greatest success, have someone credible that you know that knows a variety of venture firms introduce you to an investor. Good referral resources beyond your personal professional contacts include those experienced in working with venture firms, such as lawyers, bankers, and accounting firms. (In any case, you should be working with an experienced venture law firm as you form your company, and many of these lawyers work with a wide range of VC firms.)

If you don't have access to such resources, then be sure to do your research to understand the investing profiles of the firms and make contact with the ones that meet your profile best. Send in a 1-3 page executive summary that describes your business and team, and follow it up with a phone call to ensure it was received and is "in process". If you can, try to talk briefly to the associate or partner that will review the

plan and quickly explain why you thought your business was a good match for their firm.

What is the most common mistake entrepreneurs make?
In my opinion, the most common mistake made by entrepreneurs in the information technology field is their predilection for focusing on building products, not *businesses.* Sometimes, they are building a "better" version of something that already exists, when the customers aren't really interested in buying a "better mousetrap." Other times, they are building a new product that no one really seems to need; these kinds of "concept" companies must really excite the imagination of the investor in order to justify an investment.

Before investing all of the physical, financial and emotional energy it takes to build a company or a product, try to objectively assess if you have the makings of a successful business as well. Recognize that you and your product team may need help in learning how to build a company and a business. If you do, consider working with early stage venture capital investors that provide guidance on building and operating businesses, in addition to seed capital.

About the Author

Darlene Mann joined ONSET Ventures in 1996 as a Venture Partner following more than 10 years specializing in software marketing and sales in high growth companies. Founded in 1983, ONSET Ventures specializes in seed and start-up investing in the fields of information technology and medical technology. In her career, Darlene held positions working in a number of venture-backed start-ups as well as larger organizations, including vice president of marketing at Avantos Performance Systems, co-founder and vice president of marketing at BroadVision, Inc. and senior product marketing positions with Lotus Development Corporation, Verity, and Paramount Communications. At ONSET, Darlene now specializes in early stage investments in software and information technology companies. She can be reached at:

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