NOTHING VENTURED, NOTHING GAINED

Of the many routes to securing funds for business development, the venture capital industry is one of the most traditional and well-tested, as **Keith Arundale** reports.

Despite some rumours to the contrary, venture capital is alive and well in today's financing climate. Recent data from the British Venture Capital and Private Equity Association (BVCA, which is the industry body and public policy advocate in this field in the UK) shows that some £343m of venture capital was invested in 431 companies in 2012, a similar amount to that invested in the previous year. 64% of this money was invested in ventures at the seed, start-up and early stages with 36% invested in later stage ventures. The average amount invested at the venture capital stages taken together was just short of £800,000.

While venture capital represents just 6% of the total amount invested by UK private equity firms, with the vast majority of private equity going into management buy-outs and buy-ins (46%) and expansion/growth capital (26%) the data shows that there is indeed money available for start-up and fast growth businesses in the UK that meet venture capital firms' investment criteria. This is despite some former venture capital firms, such as 3i, having refocused their investments away from the early-stage part of the asset class to concentrate on growth capital and management buy-outs.

Latest available data from the BVCA shows that the performance of venture capital funds has been improving. Venture funds formed from 2002 onwards have returned on average 5.9% per annum since inception of the funds to 31 December 2013. This compares to a negative performance of -1.3% per annum for venture funds formed between 1996 and 2001 (corresponding to the 'dot com' boom period) and to 14.1% per annum for the private equity asset class as a whole. However individual venture funds have produced huge returns, far in excess of these figures, reflecting the high-risk 'home run' nature of venture investing whereby outlier investments like an eBay or Facebook return the fund many times whereas other investments fail to recover their costs.

> 'If you are an entrepreneur or management team seeking finance to start up or expand your business you should first of all maximise any internal sources of finance'

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The pros (and some cons) of venture capital finance

So where does venture capital fit into the financing cycle for early-stage, high-growth potential businesses?

If you are an entrepreneur or management team seeking finance to start up or expand your business you should first of all maximise any internal sources of finance, eg by improving working capital management, then seek capital from the so-called 'friends, family and fools', research the possibilities for bank finance, which for many ventures will simply not be available to you, and look into equity finance from wealthy individuals and business angel networks.

Also consider equity crowdfunding and any government finance that might be available to you. A good starting point in weighing up the sources of finance available to you is the *Business Finance Guide* which has just been published by ICAEW's Corporate Finance Faculty and the British Business Bank.

Venture capital (VC) finance should not, however, always be considered as finance of last resort. It does have several advantages:

- it provides a solid capital base for the future, to meet growth and development plans (VC funds usually reserve monies for follow-on investments);
- there is no repayment during the term of investment;
- there are no interest costs;
- it entails a business partnership with the VC fund, sharing the risks and rewards and benefiting from its advice and expertise;
- no charges on business assets are needed;
- no personal guarantees are required; and
- if the business runs into difficulties, the VC firm will work to help the company turn this around if possible.

On the downside you will have to give up some of the equity in your business and the venture capital firm may well insist on veto rights over major decisions in your business (even if the firm does not actually control your business through equity ownership).

Approaching a venture capital firm

Having decided on venture capital financing for your business, how do you go about approaching a venture capital firm? You will need a business plan which sets out your business model, formally assesses the market needs and competition, reviews the business' strengths and weaknesses, identifies the critical success factors and explains the strategy, tactics and actions to achieve

profitable growth. The business plan does not need to be, and should not be, a huge document. In addition to setting out the strategy for your business and indicating the amount of finance you require based on as realistic cash flow projections as possible for an early-stage business, its main purpose in the finance raising process is to secure an initial meeting with the venture capital firm.

Do be selective in which VC firms you approach. Avoid the 'scattergun' effect. Only approach those where your investment proposition meets their investment criteria. Venture capital firms receive around 1,500 propositions a year and maybe invest in just one or two.

An introduction from one of their portfolio companies or from a trusted adviser is preferable to sending in plans cold. The BVCA publishes a Directory of Members which lists the investment criteria (preferred investment stage, industry sector and geographic focus) of member private equity and venture capital firms so this can be a good starting point if you don't have any mutual contacts that can refer you.

Evaluating the investment proposition

If the venture capital firm executive who reviews your plan is sufficiently interested in your proposition then he or she will certainly want to meet with you and your team. They will be evaluating factors such as those set out in the box, above right.

The venture capital firm executive will make initial enquiries with existing and potential customers, industry bodies and sector specialists as necessary and will check out the team's CVs. Many VC firms these days have operating and even entrepreneurial experience in the sectors in which they invest and are not wholly from financial and investment backgrounds.

They have well-developed networks of sector experts and can pick up the phone to corporates, university professors, market experts and their existing and previous portfolio companies to check out technologies and trends. From their in-depth experience in the sectors and from meeting many other aspiring entrepreneurs they have formed their own views on market needs and growth potential.

Friendly, or not so friendly, term sheets

Assuming satisfactory answers to their inquiries and the above questions, which may well involve you in a series of meetings with the venture capital firm executive and even a presentation to the entire partnership, you may receive an offer letter (term sheet) setting out the terms on which the venture capital firm is prepared to make an investment in your business.

To do this they will have arrived at a valuation for your business using your projections, their sensitivity analyses on these projections, their recalculations and discussions with you. The term sheet will usually include many of the following areas:

- the amount to be invested, instruments (eg convertible preferred shares), valuation, capital structure;
- liquidation preferences, dividend rights, conversion rights, anti-dilution protection, redemption rights, lock-ups, pre-emption rights;
- board composition, consent rights, information rights;
- warranties, vesting, option pool, milestones; and
- confidentiality, exclusivity, fees (who bears the costs of due diligence etc), conditions precedent.

Bear in mind that the term sheet is a letter of intent, it outlines the framework for the final deal but is not

KEY QUESTIONS TO ASK BEFORE SEEKING VC FUNDING

- Is the product or service commercially viable?
- Are you solving a big problem?
- Is your solution unique?
- Is there potential for rapid and sustained growth to take a market-leading position?
- Do you and your team have the ability to exploit the potential?
- Have you already built up credible momentum with customers?
- Do you and your team have the ability to control the business through the growth stages?
- Does the possible reward for the VC firm justify the undoubted risk?
- Does the anticipated financial return on the investment meet the firm's investment criteria?

> ‘Take advantage of all they have to offer, other than the money, including access to their networks’

THE FINANCE AND MANAGEMENT FACULTY

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binding, except for confidentiality, exclusivity and fees. It is entirely negotiable, representing the VC funds preferred terms and is incorporated into the shareholders’ agreement at the end of negotiations prior to deal completion.

The terms will be proportionately more ‘entrepreneur friendly’ or ‘investor friendly’ depending on how keen the VC firm is to do the deal, how much competition there is from other VC firms and the amount of money there is washing around in the system (for venture deals generally not too much!).

So, for example, onerous liquidation preferences and dividend rights would not appear in an ‘entrepreneurially friendly’ term sheet. A number of early-stage VC firms have signed up to a standard form of term sheet and some include proformas on their websites.

Do obtain term sheets from a number of venture capital firms if you can, shop around, take the best terms for you – but do also bear in mind that the chemistry between you and the investment executive that you will be working with is also hugely important. You will be working with these guys for a number of years so there needs to be absolute trust between you and the VC firm and continual communication facilitating no surprises on either side. Take advantage of all they have to offer, other than the money, including access to their networks maybe to help you expand overseas, access to other VC firms and corporate venturers (who are increasingly financing both early- and later-stage ventures) via syndicates for further rounds of finance, access to strategic partners and acquisition targets, help with exit strategies, personal mentoring and a sounding board for strategic and other decisions.

And so to completion

Once you have accepted a term sheet you agree not to deal with other venture capital firms in your current financing round (the exclusivity provision). This allows the VC firm to conduct any external due diligence as necessary to supplement their preliminary enquiries. Formal legal and any intellectual property due diligence will almost certainly be included here.

Depending on the results of this external due diligence the VC firm will either complete the deal, seek to renegotiate the terms of the deal or in the worst case abort the deal.

Assuming all goes ahead the shareholders’ (subscription) agreement, investors’ rights agreement, warranties and indemnities, directors’ service contracts etc will be finalised and you can embark on the growth phase of your business, now suitably financed, living in a close working relationship with your VC investor until exit.

For more information on the venture capital investment process, see the BVCA’s *Guide to Private Equity* written by Keith Arundale available for download at www.bvca.co.uk

FUND-RAISING NOTES

Asset finance

Businesses need to invest in assets of various kinds, from plant, equipment and vehicles to computer hardware and software. These can be expensive, so there are various ways to ease the pressure on your cash flow by spreading the payment over time. The main options are through hire purchase and leasing.

According to the website startups.co.uk, with leasing, you are paying for use of the asset and you do not own it at any time. ‘You are not usually required to provide a deposit. Leasing is simply paying monthly to make use of an asset. You will be tied in for a certain period of time, anything from one month to two years.’ You can renew the lease at the end of the contract. You may be able to update to the latest version of the asset and there may be a service package included with the lease.

For hire purchase, once the contract is fulfilled over a period of monthly payments, you are the owner of the asset. You are likely to be charged a deposit of perhaps 10% or 20% of the asset’s value. For more, see startups.co.uk/what-is-asset-finance

Angel investors

Finding private sources of finance can be useful to a small business, particularly where a personal touch can be advantageous. People who invest their own funds into start-ups or early-stage visitors are known as ‘angel investors’. According to the UK Business Angels Association, ‘they usually take shares in return for providing equity finance and seek to use their own experience and contacts to support the growth of the business’. These investors can invest on their own, but frequently choose to invest in syndicates, enabling them to pool their finance and knowledge, where they can take the lead or a more passive role. To find out more, see www.ukbusinessangelsassociation.org.uk

Bank loans

Your bank may be the best immediate source of funding and information about finance possibilities through overdrafts, loans and other means – you will need a good relationship with your bank, whatever you do, so sound them out first!