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IN THE TRENCHES WITH THE VENTURE CAPITALIST

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INTRODUCTION

RISKY BUSINESS

Entrepreneurship and the investment of capital in small, early-stage companies is, by its very nature, a risky business for all people.

80% of small businesses fail within a few years of their conception. And even with the financial support of seasoned venture capitalists, the rate of success is not as great as either the entrepreneur or venture capitalist desire.

POTENTIAL FOR ADVERSARY RELATIONS

To the casual observer, it would seem that an investor in a company should be a partner of the entrepreneur, working together to make the company grow and share in the rewards.

Unfortunately, this is all too often not the case. What should be an ideal partnership is frequently marred by conflict, frustration, and disappointment.

Entrepreneurs are inherently optimists, and venture capitalists are inherently cynics, which creates a natural tension. As optimists, entrepreneurs envision rapid growth, few problems, and enormous profits. And when problems occur, the venture capitalist may help solve problems, or they may suffer a crisis in confidence and "shoot the President."

ROLE OF THE VENTURE CAPITALIST

As in any profession, there are a diversity of people that make up the Venture Capital ranks. Some come from operational management experience, and others have been financiers. The differences between venture capitalists can mean the difference between success and failure in the company.

Most venture capitalists say they bring more than money to a business, carrying with them expertise, contacts, and knowledge -- their "value added." While this is true in some notable instances, there are equally notable times when there has been little or no value added.

Most venture capitalists say they are interested in "seed" capital -- money to be invested in start-up companies. However, the stark reality is that only a very few venture capital firms actually do make such seed stage investments; most are merely voyeurs.

Many venture capitalists are true investors looking for long term capital appreciation. But some members in the profession are merely buyers of stock investments at wholesale costs looking to resell their stock at much higher retail prices when the company is ready for its initial public offering.

The Captain of Your Fate?? Risks for the Entrepreneur

The goals of business are divergent from those of investors. The goal of a business is to *sell goods and services competitively at a profit,* while the goal of an investor is to *make money*. Most entrepreneurs start companies to control their destiny – making money is more-often-than-not a secondary objective.

With only a small stake in the company (i.e. 25%), the venture capitalist may actually control the company by causing the entrepreneur to lose voting power if goals are not achieved. And if the company runs thin on capital, no bank or other venture capitalist will step into the company without the full cooperation of the existing venture capitalist.

This loss of control will probably mean the entrepreneur will lose his job in short order if the company's projections are not met. According to a study at the University of Miami, start-up companies, on the average, go through 2.7 Chief Executive Officers before going public.

From the perspective of the Venture Capitalist, the removal of the CEO may be with merit, because most entrepreneurs lack the real managerial talents to develop a strong organization. But few venture capitalists prepare the entrepreneur adequately for this transition.

If, as a small business owner, you're in love with your company and love to build an organization, then beware – you'll probably be torn between two lovers: the business and making money. If you choose the former, the VC will have you removed, and if you fail to make the VC's investment goals, you'll be removed. Either way, you'll more than likely not be the captain of your ship if the VC is your first mate.

Due Diligence Required

In all the presentations in this booklet, one message comes through clearly:

> Do your homework on your Partner.
> Know his Strengths & Weaknesses.
> Understand how he will react under Pressure.

This is called "due diligence," and while venture capitalists spend much time engaged in due diligence on entrepreneurs, few entrepreneurs check out venture capitalists thoroughly, too often to the entrepreneur's eventual dismay.

Robert Porter Lynch

Golden Rules for the VC/Entrepreneurial World

by A.A.T."(Pete") Wickersham

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Mr. Wickersham spent 15 years as a venture capitalist at Bankers Trust and Fleet Ventures. More recently he has been advising in the medical health field, working with smaller companies in various ways including providing introductions to suitable venture capital sources for financing. In effect, he has been on both sides of the equation. Mr. Wickersham runs Med-Wick Associates, Inc.

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The Golden Rules

Over the years, I've developed out of experience what I call Golden Rules or Great Truths for the Venture Capital & Entrepreneurial World.

These rules I've found are generally applicable to both sides, albeit with a slightly different slant perhaps. I would like to share these with you, proceeding from some broad generalities to more specific ones applying to the various stages of the financing mating dance. These begin with the early meetings, then the negotiation - commitment, then the drafting stage, and finally the closing.

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GENERAL RULES

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General Rule #1 INSIST ON QUALITY THROUGHOUT:

Here I'm referring to quality people, a quality product or service, quality professionals providing services to the company (i.e. attorneys and accounting firms)

This point equally important to the Entrepreneur and the Venture Capitalist. The VC deal is akin to a hot house flower. Because of its fragile nature, all attention must be focussed on the business. You cannot afford to be looking over your shoulder.

This is a key rule because quality normally will save time, and saving time is saving money.

For example, in one medical device company there was tremendous wasting of time because of a poor choice of support personnel: a poor investment banker who failed in the Initial Public Offering attempt, and a second rate attorney who botched the company's attempt to get FDA approval of its continuous blood pressure monitoring device.

IF QUALITY IS NOT PRESENT, TAKE A WALK.

GENERAL RULE #2 KNOW YOUR PARTNERS:

Companies seeking Venture Capital financing are usually very young companies and very high risk situations, Accordingly, one can figure on the company having some problems along the way.

Indeed, one highly regarded and battle scarred Venture Capitalist once told me that he had found that his successful deals invariably had three major crises at some point before he "cashed out." In this milieu, the necessary relationship between management and the Venture Capitalist must be one of partnership rather than Investor against Management. Hence, my choice of words -- KNOW YOUR PARTNERS.

For the Venture Capitalist, this means:

* Knowing the management team very well -- Before putting up money, be sure you can work with the management and they can work with you -- there must be trust both ways.

* Knowing your co-investors -- it is critical to have a cohesive Investor group; usually this becomes a problem when individual investors are mixed with professional Venture Capitalists. If the investor group is comprised of a number of Venture Capital firms, make sure you can work with each firm. Deals can blow apart here also. In general, keep the size of the group down.

For the Entrepreneur this means:

* The Entrepreneur should study his investors -- the chemistry must be right or there will be trouble. Entrepreneurs will want to make sure the Venture Capitalist can bring more to the table than just money. It also helps to have Venture Capitalists who are familiar with your industry. You also should check on the reputations of the firms you are dealing with, for there are some firms worth avoiding. Likewise, check the reputation of the firm's representative with whom you are dealing. Also, make sure you have a Lead Investor and that you can work with him. The Lead Investor must be perceived as such by all members of the investor group.

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NEGOTIATING RULES

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NEGOTIATION RULE #1: WATCH OUT FOR RENEGOTIATING

Usually a constant renegotiating of major or fine points will be the sign of a flaw in the psychology of either the Venture Capitalist or the Entrepreneur. This type of fine tuning or second guessing will manifest itself time and again later in the deal.

NEGOTIATION RULE #2: WATCH OUT FOR ADVERSARIAL RELATIONS

If the negotiations become adversarial rather than give and take, watch out. It's probably time to take a walk, because the adversarial nature of the relationship will only get worse under real pressure.

NEGOTIATION RULE #3: EVERYONE SHOULD BECOME A MILLIONAIRE

The Venture Capitalist should strive for a deal structure that will make management millionaires. Historically, the record shows that such arrangements have yielded very handsome pay-offs for the Venture Capitalist as well as the Entrepreneur. Following this rule increases the chance of a WIN/WIN relationship.

NEGOTIATION RULE #4: KISS (KEEP IT SIMPLE STUPID)

The KISS principal should be adhered to by both sides. Too complex a document will bog down the negotiations, and also runs the risk of tieing the hands of the management too tightly. In this same vein, do NOT fine tune the pricing of the deal to precisely. Holding out for a few cents per share or even a few dollars often will have a minimal impact on the final return.

NEGOTIATION RULE #5: MATCH THE DEAL STRUCTURE TO THE COMPANY

Early Stage companies are different from later stage ones. Be realistic in structuring the form of investment to meet the stage of the company's development. Thus, don't use a debt instrument on an early stage Investment.

NEGOTIATION RULE #6: PREPARE A TERMS SHEET

Be sure to have a brief summary sheet (1-2 pages) so that both sides then know what has been agreed to. This also keeps attorneys more focussed and hopefully keeps them out of the negotiating role.

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PRE-CLOSING RULES
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These rules are applicable after an investment commitment has been made, but prior to the date of the closing. Usually this is about a one month period.

PRE-CLOSING RULE #1: BEWARE OF THE ZEALOUS ATTORNEY

Beware the attorney who tries to change the deal in drafting papers. BOTH SIDES LOSE; BOTH SIDES MUST BE VIGILANT.

PRE-CLOSING RULE #2: BE PATIENT

Both sides must exercise great patience. Glitches are bound to come up. Attorneys or the representative of the Venture Capital firm may get sick or leave their firms in the middle of drafting. Certain documents are suddenly delayed at the eleventh hour. Scheduling problems become more severe with the increase in the number of investors, because it is likely that each Investor will have their attorney involved.

PRE-CLOSING RULE #3: VENTURE CAPITALIST'S ATTORNEY DRAFTS

The Venture Capitalist probably will insist on his attorney drafting the papers, as his attorney obviously is more familiar with his style, and probably more familiar with the Venture Capitalist's deals generally than the entrepreneur's attorney. Because of this familiarization he probably can get the deal documented faster. Accordingly, the entrepreneur is usually well served in acceding to the VC on this point.

PRE-CLOSING RULE #4: ATTEND TO DETAILS WITHOUT BEING ENSLAVED

As the papers are drawn up they seemingly take on a life of their own. Thus, even the "simplest deal" becomes encumbered with a large number of documents and the tonnage of paper consumed is unbelievable. As you can imagine and would suspect, ERRORS INVARIABLY CREEP IN. Accordingly, your attention to details when reviewing the documents is critically important. However, you must know where to focus your attention or your review will get bogged down. A trusted and experienced advisor can be very helpful here.

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CLOSING RULES

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Finally!! The Closing! There will be a meeting of all the principals and their attorneys. On this occasion, the following rules apply:

CLOSING RULE #1: BE PREPARED FOR SNAFUS

SNAFUS virtually always occur despite the best preparation of highly competent and experienced attorneys -- it is a function of the massive documentation. These problems will be overcome, however, and the checks eventually will pass hands.

CLOSING RULE #2: CONGRATULATIONS & CAMARADERIE

When all documents have been executed and the checks presented to the company, I STRONGLY ADVISE THAT BOTH SIDES HEAD FOR THE NEAREST OASIS FOR A CONGRATULATORY DRINK -- OR 2 OR 3 -- TOGETHER, WITH A GREAT SHOW OF CAMARADERIE.

This rite is MOST important, for the honeymoon, I promise, will be short-lived!!!!!

HOW TO CHOOSE A VENTURE CAPITAL PARTNER

by Dana Callow

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Dana Callow is one of the co-founders of Boston Capital Ventures, a $40 million venture capital fund in conjunction with Prudential Bache. Prior to his career in venture capital, Mr. Callow served as a management consultant to numerous business.

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DUE DILIGENCE

Before entering into any business relationship with a venture capitalist, it is vital that the entrepreneur engage in an active screening of the venture capitalist, just as the venture capitalist will screen the entrepreneur. The entrepreneur must know the integrity, goals, and operating style of their potential business partner.

Most entrepreneurs don't do a tenth of the due diligence they should. The first thing to do is to ask questions:

* What stage is the Venture Capital Fund? How successful has it been?
* What is the Venture Capitalist's Investment Strategy? Does it match with the investment firm's organizational structure?
* What are the Investment returns desired? How negotiable are these?
* What is it like to do business with these people?
* Talk to all portfolio presidents. Does the Venture Capitalist keep promises?

In our firm, we make the strategy and structure match by assigning only 5 companies per partner. This enables us to give more attention to our portfolio companies, unlike other firms that have up to 15 companies per partner.

This policy requires us to have much higher Returns on Investment and fewer failures. Our Investment Criteria is a 10-fold return in 3-5 years, which is non-negotiable. Our philosophy at Boston Capital Ventures is: one deal at a time, and make it happen.

TIME TO COMPLETE THE DEAL

For us, making an investment in a company is not a rush job. Typically, we spend 6 months with a deal learning about the business and the people, before we decide to invest, and then another 3 months to review the structure of the deal and draft the paperwork for closing.

Persistence and Patience

This time period is one of evaluating the persistence and patience of the entrepreneur. And the entrepreneur should be doing the same of the Venture Capitalist.

Each should be determining if the other will stick it out through thick and thin, for persistence is one of the best indicators of potential success.

Structuring the Deal

There are certainly many ways to structure a venture capital investment. However, let me mention just one way that overcomes many of the problems of early stage valuation, unknown risks, and product development uncertainties. It is called a Variable Valuation Deal.

We will consider this arrangement when we can't determine the real valuation of the company. In this type of valuation, we will jointly set milestones for the company to meet an incremental plan of achievement. At each step of achievement, another incremental investment will be made. This reduces our risk and exposure, and allows the entrepreneur to demonstrate the accuracy of his projections.

Power and Control

Much has been said about the power and control issue in a venture deal. Often the issue boils down to one item: Percentage of Ownership. For us, the overriding question is not, who has majority control at the early stage? but, is there sufficient incentive for the entrepreneur to continue over the long haul?

We believe that a sufficient carrot is to ensure that management has at least 20% of the company at the last round of financing.

The Venture Capitalist will always want to cover his risks first, and the worst risk is that the company will go belly up. By holding a large voting block of stock, the venture capitalist can change the most influential portion of the business -- top management -- in order to protect his investment.

Establishing a Working Relationship

Once a deal has been finalized, it will be important to establish a good working relationship, because it is to the entrepreneur's advantage to have the venture capitalist working for him.

Typically, there are always unwritten objectives that both the entrepreneur and venture capitalist have for the company. In establishing a working relationship, these unwritten objectives should be discussed early on, and any differences ironed out as soon as possible.

Be sure the Venture Capitalist has a job or task to accomplish for each board meeting. The task may be to assist in executive search, business strategy development, analyzing the competition, or helping with an entre into a good potential customer.

Management decisions should be based on good information, and the entrepreneur should be using the venture capitalist regularly to help find this information. At Boston Capital Ventures, we come from a consulting background and have good access to this type of information.

Communications with the venture capitalist is a very critical item. At Boston Capital Ventures, we don't let more that 3 days go by without talking to all our CEOs. Every entrepreneur should spend the extra effort to find a Venture Capitalist that will spend the time communicating to the company between board meetings.

Boston Capital Ventures considers itself an active Business Partner, not just an investor of money. We expect to transfer our relationship with other business contacts to help make our portfolio company more successful.

VENTURE CAPITALIST BEHAVIOR

A Venture Capitalist has a lot of risk in each portfolio company, and he is therefore always evaluating the company. His most important question is: Can this president make the plan? If not, the whole investment may be in jeopardy. If you miss the plan, it's a whole new ball game. Once the company loses a Venture Capitalist's support, there will be a serious problem.

This constant evaluation originates from the Venture Capitalist's fear of the ULTIMATE PROBLEM -- where are we going to find more money if it is needed? If there is not a strong CEO, other Venture Capitalist will be reluctant to ante up with further funding.

There is collusion in the Venture Capital market; and when the entrepreneur runs out of money, will the initial Venture Capitalist bring in other VC's? And if others are brought in, will the initial VC be forced to let the next investors establish the price of the stock because the company is too weak to set its own price?

Many Venture Capitalists, however, undermine the role of the President by constantly nipping at his heels, and demonstrating a cynical attitude a board meetings in front of other top managers.

Future Role

The Venture Capitalist should have a further role, which at a minimum may include assisting with future rounds of venture capital financing, an acquisition, or initial public offering (IPO). We want 8 quarters of profitability before and IPO, which usually ensures a high quality, high return stock offering in the public markets.

Stronger Venture Capital firms should also be helpful in establishing distribution relationships overseas, etc.

ENTREPRENEUR'S VIEW OF HOW TO NEGOTIATE THE BEST DEAL

by Frederick Graswald

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Mr. Graswald was the founder and CEO of Sweet Micro Systems, a technology company that produces computer systems. Prior to that, Mr. Graswald was senior accountant for Arthur Anderson. He currently serves as Vice President for Tillotson-Pearson.

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SOME NEGOTIATIONS ARE EASIER

Some negotiations are going to be far easier than others, just because of the nature of the industry. Each year, some industries are going to be considered “hot,” such as computers in early 1980's, bio-technology a few years later, etc.

Similarly, new world-class technologies, and successful executives who have previously run new ventures and negotiated with venture capitalists will find it a lot easier to raise capital than if you have a widget in your pocket and think it will make you millions.

EVERYONE ELSE MUST RETURN TO BASICS!

If you do not fall into one of these hot categories, securing financing will be somewhat more difficult, and you must return to the basic rules of finding financing. Some of these rules follow:

RULES BEFORE SENDING OUT THE BUSINESS PLAN

RULE #1: MAXIMIZE THE VALUE OF YOUR BUSINESS BEFORE NEGOTIATING DETAILS

Before sending out your Business Plan, be sure your business plan adequately covers the right issues. A lot of venture capitalists will read over the business plan, and if they like it, they will take out a note pad and calculate a value for your company, and that value is the value they will stick with.

RULE #2: PRODUCT SHOULD BE <u>DEMAND PULL</u> NOT <u>TECHNOLOGY PUSH</u>

It is vital that there are buyers in the marketplace that are <u>ready</u> and <u>willing</u> to purchase the product now. If you are out trying to find applications for the technology while raising money, both jobs will be extremely difficult, and your company's valuation is likely to be quite low.

RULE #3: SHOW VISION IN YOUR TECHNOLOGY WITH FOLLOW-ON PRODUCT STRATEGY

Know what product will come on line next, and after that. One product companies are less desirable. Patents or other protection should be in place or obtainable. Develop measurable milestones of product development.

Know what product will come on line next, and after that. One product companies are less desirable. Patents or other protection should be in place or obtainable. Develop measurable milestones of product development.

RULE #4: KNOW YOUR TARGETED INDUSTRY FAR BETTER THAN THE VC.

Know the price performance characteristics of your product. Show that you have done extensive creditable market research. There is no better way to lose credibility than to have a Venture Capitalist come in and tell you all the things you don't know and will be doing wrong.

Your market should be able to grow to $250 million and your company should reasonably be expected to garner 15% to 25% of market, enabling your company to grow to %50 million in sales in 3 to 5 years. Companies without this growth potential will probably not finalize a deal with the Venture Capitalist.

RULE #5: HAVE A FULLY QUALIFIED MANAGEMENT TEAM

For start-up situations, when it is impossible to have a full team on board, have one leader or spokesperson who is well qualified and articulate. If CEO is not on board yet, don't be afraid to state in the business plan that that person will be hired first, and then will select rest of the management team.

RULE #6: KNOW YOUR SALES CHANNELS

A lot of people will bring out a product and not have the sales channels well defined. Plan for training of your sales force or end users and product service. Schedule the measurable milestones of sales and marketing.

RULE #7: HAVE A GOOD COMPETITIVE STRATEGY

You must have an effective competitive strategy. How are you going to maintain 15-25% of market share as competitors vie for a larger chunk of the market place? Know the strengths and weaknesses of your competition. Know the barriers to entry and the cost to overcome them. Know how to defend the product life cycles for your products. And remember:

NO COMPETITION MEANS THERE IS NO MARKET.

RULE #8: HAVE A CLEAN LEGAL BILL OF HEALTH

It's a lot easier to raise money if you have a clean legal bill of health. You don't want to go into negotiations with a possible law suit from your former employer for stealing technology (patent infringement, etc.).

RULE #9: HAVE THE MANAGEMENT TEAM ANALYZE ITS PERSONAL GOALS

Before entering negotiations with a Venture Capitalist, sit down with the rest of your management team and clearly state your financial and career objectives.

The business package should, ideally, represent the fulfillment of your team's personal and professional goals from a career perspective.

RULE #10: MAKE THE INVESTOR'S DUE DILIGENCE EASIER

Have a list of references that the Venture Capitalist can check up on rapidly. Have good references both individual and corporate (i.e. customers and suppliers).

RULES OF NEGOTIATIONS

Once you have set the stage and you have Venture Capitalists interested in your company, negotiations begin. The Venture Capitalist probably has a perceived value already regarding what he thinks the company is worth. These principles apply:

RULE #11: START WITH A POSITIVE MENTAL ATTITUDE

I come from a background as a financial officer and auditor. I do not have a positive mental attitude. Therefore, in our negotiations, it was important to have our chief negotiator have an up-beat attitude; so we chose our VP of Sales and Marketing.

Believe in your product and success. If you have some elements of the business you can control, string out your good news during the negotiating process - have the telephone ringing.

RULE #12: HAVE A PASSION TO SUCCEED

The management team, itself, must have passion to succeed and be focused on the same corporate goal. All too often, members of a team will want to succeed in their own area, but not together and not necessarily for the betterment of the company. The CEO must mold the team for company success.

RULE #13: EMPHASIZE THE PROPRIETARY COMPONENT OF THE COMPANY

Always stress the unique aspect of the company, whether it be a unique sales channel, the technology, the product. Don't stop convincing the investor of this uniqueness.

RULE #14: BE REASONABLE

Be reasonable, if you can't succeed neither will the Venture Capitals. Oftentimes, and entrepreneur who has spent years developing a product will find it difficult coming back to the real world, especially when several venture capitalist all give your company a lower valuation than the entrepreneur imagines the company to be worth. Consult with outside experts when in doubt.

But unless the venture capitalist has put enough incentive in the deal for you to become a millionaire, the deal probably won't work.

Be prepared to give on the downside; don't fight for security (employment contracts, officer loans, etc.) If the business fails -- these are not in the realm of the Venture Capitalist's world.

RULE #15: KISS -- KEEP IT SIMPLE STUPID

KISS minimizes time to negotiate the deal, as well as attorney's and accountant's fees. KISS also maximizes the time to concentrate on business. Don't let the deal become so simple that you end up losing future earnings potential.

RULE #16: USE TOP QUALITY ADVICE

Use top professionals for legal, accounting and market research. If you are not familiar with negotiating deals, then get an advisor, because you can make some very fatal mistakes. Your advisor can also make sure the Venture Capitalists have deep enough pockets to fund growth or adverse trend and that you have a good lead investor. Can the Venture Capitalist provide contacts, contracts, distribution or technology?

RULE #17: OBTAIN FINANCING BEFORE YOU REALLY NEED IT

It is much easier to negotiate from success than failure. Have a plan for future capital needs ranging from proto-type, beta testing, marketing, and manufacturing. Get enough money to attain the next milestone, so you can run the business instead of looking for money. Prepare a detailed schedule showing application of proceeds. Have financial statements current and audited or reviewed. Make the most of any local or regional financing programs.

Plan the time commitment to close the deal. (Three to six months -- look for money long before you need it.) Develop local and national bank contacts for debt financing which will reduce the dilution of your business.

RULE #18: BE ABLE TO SUBSTANTIATE THE COMPANY'S VALUE

When negotiating on price, show comparable pricing on other deals and comparative companies who have succeeded. Vigorously defend your valuation of the company. Don't give in on your perceived value, defend it with concrete facts, (e.g. detailed market analysis).

Drive up the perceived value of your company by using mirrors for publicity and recognition such as articles in trade magazines, etc. Work hard on public relations during the pre-negotiating period.

RULE #19: KNOW THE ISSUES YOU SHOULD WIN

From my experience, the one item you have the most leeway in negotiating is the Employment Agreement, which includes compensation, bonuses, vacations, stock options, etc.

The top managers should be on the Board of Directors.

Negotiate for registration rights, but be aware that the underwriters may ultimately control this at Initial Public Offering time.

RULE #20: KNOW THE ISSUES TO GIVE IN ON

Don’t try to cover your self too much on the downside. If the business fails, everyone will lose.

Also, there are standard provisions that the Venture Capitalist will require, which include liquidation preference, non-compete agreements, security for loans, ratchet provisions (anti-dilution for subsequent issues) if you do not meet plan and registration rights.

RULE #21: KNOW WHAT THINGS TO WATCH FOR

Watch out for the granting of warrants which could become hidden dilution of your interests over time. Watch the structure of the Board of Directors -- control is one thing, communications and influence is another. Be sure that reporting provisions are reasonable.

Legal fees will depend on complexity of deal, number of investors, etc.

RULE #22: TIME IS YOUR SECOND MOST PRECIOUS RESOURCE

(Money is the first!)

LAWYER'S VIEW OF NEGOTIATING WITH THE VENTURE CAPITALIST

by Dennis O'Connor, Esq.

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Mr. O'Connor is a senior partner in the law firm of O'Connor, Broude, Snyder & Aronson. His specialty is in serving smaller, high growth businesses in the Route 128 area. He has had considerable experience negotiating and drafting venture capital deals. He is also Chairman of the Capital Formation Committee of the Small Business Association of New England and is a member of the Capital Formation Group of the Securities and Exchange Commission.

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CONSIDER THE ALTERNATIVES TO VENTURE CAPITAL FIRST

In the current stock market, Initial Public Offerings (IPOs) are very attractive, and any entrepreneur should consider the alternative of "Cruising with your Investment Banker" to being "In the Trenches with the Venture Capitalist."

However, there is one principal advantage to venture capital, in that there are fewer "spikes" in the venture capital marketplace; whereas the IPO market suffers from open and closed windows for obtaining financing.

Yet, venture capital is more difficult today to obtain than in 1983, when there was an explosion of high tech investments.

HOW TO IDENTIFY LEAD VENTURE CAPITAL PLAYERS

There are now an abundance of lists of Venture Capitalists, such as seen in Venture magazine, INC magazine, etc. containing lists of people, phone numbers, and types of deals. In addition, consult lawyers, other entrepreneurs, accountants, and bankers with their personal contacts.

THE IMPORTANCE OF GOOD PLANNING AND IMAGE

The most successful money raiser I have ever met never had a successful company, but he was unsurpassed in his planning for money raising.

In the early 1970's he raised $1.5 million from several partners at Goldman Sachs. At one time he had a plant in Florida. It was totally secure with a sign-in desk, yet there was nothing in the plant except the reception area. He had the only reception area I've ever seen where the receptionist had to push a button under her desk for the door to open into the plant. The Investors loved this.

The entrepreneur would never let the investors come to the plant on their own. When they were scheduled to arrive, the entrepreneur would arrange for them to be met at the airport in a limousine, thereby never surprising the entrepreneur.

When a visit was scheduled, the entrepreneur brought in people from the street, dressed them in white jackets, and put them on the manufacturing floor. Arrangements were also made for the phone to ring at very frequent intervals.

Although not very ethical, it was very effective planning.

Just remember: Things don't happen by waiting for the check to come in the mail.

TIME PARAMETERS ARE OFTEN UNDERSTATED

Time parameters are a great factor overlooked all too frequently by the optimistic entrepreneur. To do a deal in 3 months is very fast. 6 months to a year is much more normal.

Very often the entrepreneur will see interest by the venture capitalist that is really quite misleading. The entrepreneur sees a venture capitalist's preliminary questions as "interest in my deal." With the passage of time, the entrepreneur learns that, more often than not, the Venture Capitalist is simply trying to learn about the deal.

I talked with an entrepreneur not long ago who had been seeking funds for about a year; and I commented: "You must have spoken to a lot of venture capitalists during this year."

He responded: "Not really, I talked to a lot of secured lenders who were billing themselves out as venture capitalist, and I talked to lot of so-called venture capitalists who were in the business of generating information, but I didn't talk to any real investors.

SCREENING THE VENTURE CAPITALIST

Screening the venture capitalist is a process every entrepreneur should engage in before doing a deal. Whether there is only one or several Venture Capitalist's who are interested in the deal, the entrepreneur should engage in a careful screening process.

Screening need not be expensive, it doesn't have to take too long, and if nothing else, it will give the entrepreneur an idea of what is likely to face if he goes down the road with the venture capitalist.
This screening will examine the past deals a venture capitalist has done. The entrepreneur should get the names of several of the successes and failures in the venture capitalist's stable of investments.

Then find out for those companies that succeeded, what factors led to its success. Was it follow-up financing? networking? management advice brought to the table? introduction to banks? And most importantly, what was the method of interaction between the venture capitalist and the entrepreneur?

What is the interval between Board meetings? How long did the meetings last? day? 1 day? 2 days? How much preparation was necessary for these Board meetings.

I have a friend who has a venture backed firm with 12 venture capitalist that require 60-70% of his time for communications. In this case, the venture capitalist will not allow the entrepreneur to delegate this responsibility.

In another circumstance, the lead venture capitalist insists on sitting in on all meetings of the company involving key corporate developments. A few years ago, when the company was attempting a deal with Kodak, the deal fell apart. One of the lawyers for Kodak told me later he could understand that the venture capitalist's sole goal was to protect his investment. But this was certainly not Kodak's goal, and this overly protective attitude killed the deal.

There is no magic to the screening process. It is simply doing your homework.

How the venture capitalist dealt with corporate failures is equally important. How did the venture capitalist react to changes in the plans? What was his role in the failure? How was the entrepreneur treated?

THE TERM SHEET STARTS THE NEGOTIATING

The deal starts with a term sheet of 2-3 pages or 6-7 pages outlining a set of basic terms. At this point, the formal negotiating process begins.

In the case of a start-up company that is not bankable, any money is going to come with strings attached. You should not try to eliminate those strings, but just loosen them to make them manageable.

THE "GOLDEN RULE"

The venture capitalist's Golden Rule: HE WHO HAS THE GOLD, RULES will prevail to a large extent, but the entrepreneur does not have to accept all the rules completely.

VALUATION & CONTROL

The first thing that will surface is valuation, which is usually related to the venture capitalist's speculation about future profits.

Where valuation begins to get tricky is where it involves control of the company. A 45% venture share of the company is one thing, a 55% share is completely different.

When the venture capitalist insists on greater than a 50% share level, he will typically state: "It is better to have a smaller piece of a very big pie;" to which the entrepreneur will retort: "I was looking for an investor, not a new boss." This is the point where some creativity and flexibility is required.

CREATIVE SOLUTIONS TO CONTROL ISSUES

If the venture capitalist is required to take some rather substantial risks with a very early stage company, the entrepreneur must be careful to fight the right battles with creativity and agility.

For example, if the financial commitments will require the venture capitalist to hold more than 50% of the control, the entrepreneur may then want some sort of veto power over major corporate decisions, or performance shares that are awarded to the entrepreneur if the company performs better than expected, thereby enabling him to regain control. An employment agreement may alleviate fears of being thrown out if and when control changes. These solutions enable the entrepreneur to avoid fighting the valuation battle head on.

FINANCIAL STRUCTURE

Most financial commitments now will often involve a convertible security. Seldom do Venture Capitalists want common stock in early stage companies, usually seeking convertible preferred stock or convertible debt.

DILUTION PROVISIONS

Dilution is an important point that the entrepreneur may have to give on. If the venture capitalist puts money in at $6/share, he will want protection from someone else later putting money in at $1/share.
Rachets are anti-dilution provisions in the event of future stock offerings at a lower price per share. There should not be an absolute rachet, but should be dealt with on a weighted average basis, particularly if the second investment is relatively smaller than the first.

There should be some exceptions to these provisions to these anti-dilution provisions also. Some shares can be set aside for consultants, employees, etc. These shares should not all come out of the founder's stock.

Be careful of straight debt with warrants, because there can often be hidden dilution that will hurt the entrepreneur in the long run.

NEGOTIATIONS ARE A WIN/WIN PROCESS

The negotiations should not be a win/lose process, but rather one where everybody wins, regardless of how much yelling and screaming might be going on during the negotiations.

SURVIVING WITH THE VENTURE CAPITALIST AFTER THE MARRIAGE

by William J. Kirk

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Mr. Kirk was the President of K-TRONICS, an electronics company that manufactures energy controllers. Previously he was president of Sphere Technology, a venture capital backed company that developed and manufactured voice recognition products. He has also been the vice-president of sales and marketing for Gulton Industries and a product manager for Honeywell. In addition, Mr. Kirk is a frequent lecturer on entrepreneurship and he was one of the founders of the Technology Council of Rhode Island.

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BASIC TEAM WORK RELATIONSHIP

The ideal relationship is one in which a TEAM orientation is followed and the Venture Capitalist usually states that this is the kind of relationship they want. Can this ideal relationship be established and maintained?

The Venture Capitalist is looking at the company and management in the following ways:

* is the president capable of managing the company?
* are the rest of the team doing their jobs?
* are the decisions and trade-offs being made correctly?
* is the product ready for market?
* is the market ready for the product?
* does the company need more money and what will it cost?
* are these people refundable, i.e. can they be sold to other Venture Capitalist's, are they credible?

DIFFERING PERSPECTIVES

It is possible that the Venture Capitalist has different objectives than the company and these objectives can change as the realities of the business evolve.

VALUATION

The Venture Capitalist is always looking toward signs that the company's valuation is increasing. For example, the Venture Capitalist will ask himself if the company made sufficient progress so that at the next round of funding the value of the stock can be increased. This will show up on the Venture Capitalist's books as an appreciation of their investment and will be reported to the Venture Capitalist's Investment failures deflate the value of the Venture Capitalist's portfolio and occur earlier in the game than successes. In order to make for these failures the Venture Capitalist will be looking for that direction even though in some cases it may not be in the best interest of the company.

MANAGEMENT EVALUATION

If the Venture Capitalist owns a high percentage of the company, he can be both judge and jury of the performance of management. Yet, he may only see management once a month, and it is on this basis that he will make a confidence judgement about them. He will assume that things are probably in worse shape than he is being told by the company and will often look for hidden problems.

CRISIS AND CONFIDENCE

Generally one or more members of the management are learning their jobs and their inexperience will surface - particularly under pressure.

Surprises will occur. These situations must be dealt with in spite of the pressures to which the team is being subjected. There may be a significant difference between actual and perceived company performance in spite of the operating results and reporting systems.

Management may get frustrated trying to satisfy the Venture Capitalist by pointing to the plan not realizing that they are being measured against a criteria that centers around the Venture Capitalist's confidence in management and not necessarily the operating plan.

In this environment the two sides want to work as a team!

PRACTICAL RELATIONSHIP

EXPECTATIONS

The company and Venture Capitalist should agree up front on what are the REAL expectations - surface each side's agendas and expectations. An honest discussion on these subjects is essential to establishing a framework within which both can work.

CONTINGENCY PLANNING

An attempt should be made to figure out what could go wrong (risks) and a backup plan be generated.

This is particularly important in relationship to TIME. Time is THE biggest enemy and if the product development is delayed or the market introduction takes longer than expected, then valuable time is lost. More time translates into a need for additional funding and is usually unplanned.

Somehow the pressure to meet the planned schedule must be maintained, while, at the same time, having reserve funds to cover the additional funding, which will be required.

For example, it may be cheaper to hire additional resources in order to meet the plan than to accept a slippage. If a slippage is unavoidable it should be faced up to immediately and a new plan built (including the impact on funds). Usually the slippage has resulted from unforeseen surprises occurring.

It is essential that nobody be blamed, since the company is charting new grounds and cannot possibly be completely accurate in its predictions -- something inexperienced Venture Capitalist's will not understand.

The "team" (management and the venture capitalist) must work together at this point to create a winning scenario or a bad situation will develop.

PRESIDENT IS IN CHARGE

It is also essential that the president be viewed as being "completely in charge" of the company. All members of the management team must understand that the President is the key person upon which the Venture Capitalist relies. If the Venture Capitalist loses confidence in the CEO, then the company will go down a very rocky road -- including a change in top management and a re-evaluation of the other members of the team.

The management team must not allow their egos to get in the way by showing how smart they are to the Venture Capitalist or by second guessing the president. They should practice the presentations, and in Board meetings they should take their cues from the President.

REPORTING TO THE VENTURE CAPITALIST

While the company may be going flat-out to achieve its objectives, there is still a good chance that the objectives aren't being met. The progress against the plan will normally be reported at a regularly scheduled monthly Board of Director's meeting. Both good and bad news is discussed. The company should prepare thoroughly for meetings with the Venture Capitalists as though its future depends on it (which it does). But each meeting will be a drain on precious time.

After a while there is a tendency for the company to feel that the Venture Capitalist is an interruption, and this feeling can be amplified if the Venture Capitalist asks questions that require what is viewed by management as unproductive work. Management will probably not understand the Venture Capitalist's position and will not appreciate his needs. An adversary relationship can occur very quickly if these problems of Venture Capitalist needs are not addressed.

MONTHLY OPERATING REPORTS SHOULD INCLUDE:

Monthly operating reports presented at the Board meetings should include:

* monthly and year to date financials versus plan
* explanations on deviations
* schedule review against key milestones
* critical issues
* Venture Capitalist activity on the company's behalf
* customer activity, especially Target customers
* PR activity
* shipment reviews
* quality review
* next month's expectations
* Sales Review and Forecast

The reporting process is very time consuming for management. One trap is to believe that management can perform their regular tasks as well as these time consuming reporting tasks. They can't, and if they try, they will do a poor job everywhere. It is better to be slightly over staffed under these circumstances than understaffed with the "we can manage" attitude.

MONTHLY MEETINGS

An agreement on the purpose of the monthly meeting should be reached. Is the meeting a Board Meeting? an operating review? or a free-wheeling problem solving session? Do not get trapped into believing that the meeting is a problem solving session when it is being measured as though it were a Board Meeting.

Hold formal Board Meetings at least every 3 months. Board participation should be kept separate from operations. Most Venture's will want a seat on the board and these meetings should be very formal and well run.

The company should focus a large percentage of the Board meeting on external considerations such as prospects, customers and competition. The Venture Capitalist can make some valuable contributions in this area. Nothing will lose the Venture Capitalist's confidence quicker than not knowing what the competitors are doing and not understanding the marketplace. The Venture Capitalist may be able to bring competitive information to the company; he may be able to open doors at high levels in prospective customers not available to the company.

Above all, give the Venture Capitalists some appropriate assignments, make them part of the plan, include them in the scheduling and reporting process and keep them busy. Make sure that the Venture Capitalists are performing the role of representing the company in the financial community. This is an ideal role for them and one that the typical entrepreneur usually can't perform effectively.

Operational meetings should be kept separate from board meetings. By all means have 1 or 2 Venture Capitalist's on an operating committee but do not involve too many at the detail level since many will not understand the intricacy of running a new company.

Rely on the operating Venture Capitalist to communicate with the rest of the financing Venture Capitalist's if there is a need for information between board meetings. Make sure he can give advice without viewing you as weak for needing it in the first place!

REFUNDING PLAN

In conjunction with the Venture capitalist, making a refund plan.

The Venture Capitalist should take the lead on the re-financing drive, but be careful about simply dropping this task in his lap. Your company will run short of cash if your Venture Capitalist is too busy with other tasks to put enough effort into working on your funding. If this happens, you may be forced to agree to financing or ownership of small companies this way. The president is ultimately responsible for negotiation the final agreement and should not let the situation get to the point where the company is in a weak bargaining position.

The plan must be at least a year ahead of the need and include milestones of events which, once achieved, will increase the valuation of the stock.

A contingency funding plan, in the event of missing commitments, ought to be prepared. Re-financing with additional outside investors takes at least 6 months, more often 9 months to a year, so prepare early.

Prepare a "due diligence" program to help smooth the way for new investors.

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