

Frequently Asked Questions About Venture Capital

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What is venture capital?

Venture capital is money invested in a private company to be used for growth. While the public uses the term "venture capital" broadly, the investment community uses the term to describe investments in start-up or early-stage companies. Companies at these stages don't have an established track record, don't have all the pieces in place for success and are very risky for an investor. A start-up or "seed stage" company typically has a product or technology that has not been proven successful in the marketplace. An early-stage company may have proved a product or technology in a limited market but is seeking to expand significantly.

In contrast to venture capital, the investment community uses the term "private equity" to describe investments in mature companies that have some track record of success and typically are generating positive cash flow. Companies that are candidates for private equity often have a complete management team in place and an established customer base.

Why do companies need venture capital?

Understanding the context of sources of funds is helpful to answering this question. Picture a balance sheet. Generally, the claims of creditors and owners are listed from the top to the bottom in the order of the priority of their claims to the company's assets, including cash. At the top of the heap are the secured lenders, typically banks, also called "senior" lenders. Senior lenders are not willing to accept much risk. Moving down the balance sheet, you might find subordinated lenders and trade creditors, which get paid after the secured lenders but before the stockholders. Once all creditors are paid, the stockholders are entitled to the company's assets. Among stockholders, some may have superior claims to the company's assets over others. Preferred stockholders have the most senior claims, and among preferred stockholders, seniority may differ. (Usually, the most recent preferred stock investor holds the most senior claim among all of the stockholders.) Finally, at the bottom of the pecking order is the common stock, which has a claim to whatever is left after everyone else has been paid what they are owed.

Of course, an investor always expects a return on his or her money. When there is more risk of getting paid, the investor requires a higher return on his or her investment to justify the increased risk. Getting back to the balance sheet, the banks currently require a return on their investment, also known as interest, of around 4-6%. A subordinated lender may require returns of around 14-18%. An equity investor will require even greater returns, depending on the stage of the company and the risk associated with the investment, because the equity investor will be paid, if at all, after the creditors.

Now to answer the question why companies need venture capital. Remember that banks don't like much risk. A mature company with healthy cash flow is a good customer for a bank, but a bank will only loan money to the extent the company can reasonably show that it will be able to safely pay back the loan with interest. A mature company has only so much cash flow and ability to repay debt. A start up or young company has no chance of getting a bank loan unless the loan is based on the personal guarantee of the owners. Enter venture capital or private equity. Because these investors are accustomed to risk (and want to get paid for taking it on), they are willing to invest in a good business.

(On a side note, keep in mind that a company can only pay so much of its cash to service a debt or equity investment. Investors know this, so they expect the bulk of their return to come when they sell their ownership stake to a third party.)

What is expected of companies that get venture capital?

Before deciding to seek venture capital money, an entrepreneur should decide what he or she wants the company to be in the future. At some point, investors want their money back, and they are not interested in financing a company so that you can hand it to your grandchildren. Typically, investors get their money back (or "liquidity") three ways; selling the company to a third party, selling their stock in the market after the company goes public or selling their stock back to the company. The first two scenarios represent a fundamental change in the company and the last scenario represents a significant drain on the cash of the company that may hamper the company's ability to grow. The entrepreneur must be willing to live with one or more of these scenarios.

Some entrepreneurs are concerned about giving up control, and rightly so. Keep in mind, however, that not all investors are looking for control. Some professional investors will only invest in situations where they will be the majority owner and some professional investors prefer to invest as a minority owner. How much ownership of the company you have to sell is a function of how much money you need to raise and the value of your company. Regardless of the ownership percentage held, professional investors will place restrictions on

the company's ability to engage in certain kinds of transactions like mergers without the approval of the investor.

To attract venture capital, a company needs to show a credible plan of how the money will be invested and how the company (and correspondingly, the investors) will benefit. Although there may be a written description of the plan, an important component to obtaining venture capital is to have supportable projections of financial results for the company for 3-5 years into the future.

Once the investment is made, the investors will expect the management team to achieve the projected results. Investors will want to be informed on a regular basis of the company's progress. Depending on the type of investor, this may range from frequent calls with the management team to passive receipt of quarterly financial statements. Although some investors may be more actively involved in the business than others, investors generally would prefer not to have to spend a lot of time with the companies in their investment portfolio.

Finally, and this issue is frequently overlooked by entrepreneurs, management needs to understand that different skill sets are needed depending on the life stage of a company. Early on, companies are frequently led by visionaries who perform a variety of roles. As a company grows and matures, at some point it has a strong need for professional management. Occasionally, the same person can lead companies at both the early and mature stages, but frequently there will be a leadership change. As a business owner, you should have a conversation with potential investors about this issue. For yourself, you will have to decide which you value more - being in control of a successful, but perhaps small company or being one of several owners of a successful, but larger company, and dealing with potential differences of opinion on how to manage and grow the business.

How does a company prepare to raise venture capital?

A seasoned veteran of venture capital investing once said "Always bet on the jockey, not on the horse." In other words, a great idea or product won't be profitable without a great management team. You will have a better chance of getting an investor's attention if you have in place the key members of the management team that have experience in their field. You don't have to have everyone in place, especially if you're a young company, but having gaps in the team creates more risk for the investor.

You should also have a credible plan in place. Be very careful about the hockey stick. The hockey stick is a graph of the company's revenues that starts out flat and curves upward sharply. It is very difficult to achieve and maintain rapid growth and investors know that.

Who provides venture capital?

There are basically three sources for a small company to raise money - friends and family, angel investors and professionally managed venture capital and private equity funds. I keep in mind, however, that the process of seeking investors is subject to regulation and you must be careful to comply with securities laws discussed below.

Perhaps the easiest to obtain with the least number of conditions is money from your friends and family. Unless you've got wealthy friends and family, however, the amount you will be able to raise is limited.

Angel investors are high net worth individuals who invest in companies for the potential return, but also for other reasons including wanting to help entrepreneurs. Historically, angel investors were loosely organized, if at all, and finding one depended upon your rolodex. Over the past several years, angel investors have become more organized. Typically, a group of angel investors in a particular geographic area meet together to hear from companies looking for capital. Under this model, each angel investor decides whether to participate in each investment. There are currently two angel groups in South Carolina, Columbia Angel Partners and Charleston Angel Partners.

Venture capital and private equity funds may range in size from about \$10 million to several billion dollars. Managers of these funds typically raise money from pension funds and other institutions. Unlike many angel groups, the managers of these funds have discretion over which investments will be made. Venture capital and private equity funds can have an advantage over some angel groups because they can quickly make a decision and close on an investment, but this is not always the case.

One interesting phenomenon has occurred over the last decade. Just as more money has flowed into mutual funds, more money has flowed into the venture capital and private equity funds. Over time, these funds have swelled in size, but one thing has remained constant; each partner within the fund can oversee only a handful of investments. This has caused the minimum investment size in any particular company to drift upward so that in today's environment, an investment of a few million dollars would be considered small. This has created an opportunity for the angel groups to fill the gap, as many are willing to invest in amounts as small as several hundred thousand dollars.

Legal Issues

When considering the legal issues associated with raising venture capital, you should look at it from a few angles. From the positive side, a lawyer experienced in venture capital will understand what terms are reasonable to give to an investor and what terms are not. Many business owners think of lawyers just "papering up" a deal, but there are provisions in

investment documents that can be the difference between you realizing a little money or a lot of money when it's time to go public or sell the company. (Remember that while you and the investor are both interested in making the company valuable, when it comes to dividing up the pie, the investor will not be looking out for your interests.)

From the negative side, there are a number of federal and state securities laws that must be followed. Consequences for failing to follow these laws vary, from having to give investors back their money to going to jail. An experienced lawyer will help you navigate through these issues.