<u>Of Course, You Want VC Funding ... Don't You?</u>

Few start-up companies would turn down an opportunity to secure venture capital funding. And if they did, wouldn't they be out of their minds? That would be the standard answer many entrepreneurs building new ventures would give.

But, as we all know, conventional wisdom isn't always right.

Ever since the dot-com economy took off in the mid-1990s, VC funding has become known as the key to the launch of a successful company. From providing critical capital to value-added benefits such as important contacts and guidance, VCs have gained the reputation as "kingmakers."

Yet leaders of start-up ventures should stop to ask themselves a fundamental question before heading down this gilded path: Is VC funding really the right thing for my company?

<u>Are your goals compatible with VCs?</u>

Think about your goals for your business and how you want to run it. What are your financial benchmarks? Do you want a quick exit or a long-term play? Do you want to be intimately involved in every detail of your business, personally nurturing it for the foreseeable future? Is being the CEO what you want to pursue for the rest of your working life? Answering these kinds of questions can help determine whether VC funding is appropriate for you and your business.

The first thing to know about VC firms is that they are intensively focused on driving maximum returns for their limited partners and generally are best suited to work with serious entrepreneurs who have already made their nest egg and have the same "high risk/high reward" mindset as VC's.

Entrepreneurs should know that venture capitalists are interested in hitting a home run, not bunting a single.

In most cases, swinging for the fences will increase your company's risk profile, so while the odds of becoming the next big thing may go up, the odds of striking out will most likely go up even more. In other words, if you're looking to build a company with slow, steady growth, VCs may not be your best funding resource.

If your company is your baby - financially and emotionally - you may also not want to risk losing control, which is typically the reality no matter the specific equity ownership that a VC may have (I'll discuss this important, but often overlooked, topic later).

Will venture capital funding create added value for your company?

Once you answer the fundamental questions above - and they haven't led you to rule out VC funding - then you need to decide whether this type of investment will deliver incremental value to your business. Although most VCs will claim to bring significant value-adds, such as contacts or operational expertise, there are considerable differences in the track records of VCs in delivering on that promise. You should do your research on who an investor has funded and how they helped (or not).

The reality is that very few VCs are "kingmakers." Take the time to understand what specific "value-add" to expect from any VC with whom you may work. While most can help with general corporate governance and high-level advice, not all can deliver on the business development networking, recruiting and day-to-day operating advice you urgently need.

Typically, VCs sit on six or more boards, and are always actively searching for new portfolio companies. This means that they don't have the time (or in some case the interest) to dig into the details of your niche market or the unique aspects of your company to help you build your business.

Remember: their primary job function is portfolio management (buying and selling equity positions) and NOT running companies.

The practical reality is that fairly few funding general partners have personally started and built an entrepreneurial venture themselves, so it is unrealistic to expect them to bring highly relevant perspectives about how to best operate your business on a day-to-day basis.

Not all terms are created equal

Still interested? Then here's a friendly reminder: it's about more than valuation. VC term sheets have lots of moving parts, from liquidation preferences to redemption rights, and the highest valuation doesn't necessarily work out to be the best economic deal for the entrepreneur. If you are going to work with a venture capital group, it is very important that you have a good attorney who has dealt with venture capital terms before. You need to understand not only the valuation offered by the VC, but also the implications of dozens of other terms that affect "who gets what" under various scenarios.

Tips for a happy marriage

Once you have weighed the pros and cons of VC funding and determined that your company is a good fit for venture capital funding, your instinct may be to run out and hit the streets with your business plan. Slow down! You need to be thoughtful when selecting an outside investor. Certainly, finding a group that invests in your industry sector/market and your stage (concept, seed, early, etc.) is a basic starting point, but there is much more to consider.

First, make sure you have good chemistry with the VC you choose. You will be "married" to your VC for five to seven years, and like entering any good marriage, you need to make sure you share the same values and have compatible styles and outlooks with your investor.

VCs will have key management and veto rights, so you want to make sure that you will get along through thick and thin. Otherwise, business could get ugly.

No matter how good an investor may look on paper, always check your VC's references, which will give you a good idea of what your VC is made of and whether there is a good fit. Entrepreneurs are generally eager to help each other and contacting references could provide you with a wealth of important information that could not only affect your decision about getting hitched with a certain VC, but also provide new leads.

All VCs publicize their portfolios, so don't hesitate to pick up the phone and call CEOs to find out what their experiences have been. The new website www.thefunded.com will provide additional perspective on what entrepreneurs think about VC firms.

Do the reality check

As you'll soon find out (if you don't know already) there are simply no ifs, ands or buts about it: raising venture capital is hard. Many companies are competing for the attention of a few VCs, and only the brightest and most promising new ventures will stand out in the crowd.

While it is tempting to let yourself imagine that you'll end up with a full line-up of great VC options to choose from, the vast majority of companies will never see a VC term sheet, and only a few "hot" companies will actually end up with several options, and they can happily shop for the best bride (or groom) in town. The rest of the companies looking for funding will have to be content to get a single term sheet that they can nurse through to funding – but even in that scenario it is critical do the homework so you know what to expect once the deal is closed.

If VCs decide your business just isn't right for them, then keep in mind there are other funding pipelines to pursue: friends & family, angels, strategic investors or venture debt to mention a few. Whether it is a lifestyle company created for your love of luxury shoes or launching your next cutting-edge biotech venture, armed with a strong understanding of the costs and benefits of seeking VC funding should allow you to make the best decision for your enterprise.

Angel Investing 101

Angel investors are wealthy individuals who invest in high risk, early stage ventures by reserving a portion of their total investment portfolios to provide emerging companies with seed and startup capital through direct, private investments. Their goal is to achieve higher returns than the typical public markets provide. Most angels are active investors - who contribute their time and experience, as well as offer introductions to valuable contacts essential to the company's success.

Management team.
Is your team experienced, driven, coachable, and willing to cede some control and decision-making authority to outside investors?

Target customer.
Do you have an identifiable market segment?
Is there a demonstrable and significant demand for your proposed solution?

Market size.
Is the projected spending in your product category large and growing?
Can this be a $100 million market?

Competition.
Have you identified potential competitors?
Do you understand your company's differentiation points?
Will true barriers to entry help your company to maintain a competitive advantage?

Technology.
Have you proven the concept behind your product or technology?
Can this be confirmed with data or by objective experts?
Have you built a comprehensive business plan to commercialize the technology?

Protected intellectual property.
Have you protected your intellectual property?
Have you performed an exhaustive search to be sure that you are not infringing on patents or trademarks held by others?

Sales strategy.
Do you have a plan to achieve widespread market penetration for your products and services?
How will you do this as efficiently as possible?
Will you create an internal, direct sales team, or will you rely on external channel partners?

Profit potential.
Can you demonstrate how high margins (+15%) and consistent cash flow growth will be achieved?

Capital needs.
Do you require between $50,000 to $500,000 to finance growth activities, including product development, recruiting key staff, launching sales and marketing activity?

Financial projections.
Have you developed reasonable financial projections - including an income statement, cash flow and balance sheet and supporting spreadsheets - based on logical, realistic assumptions?

Exit strategy.
Do you have a clear exit strategy that will enable angel investors to generate a return of at least ten times their initial investment?

Business plan.
Have you developed a comprehensive business plan that articulates your key business strategies for how you will grow your venture?

<u>Angel Investors Criteria</u>

Management team.
We look for teams of high-quality entrepreneurs with a track record of leadership and performance - either in the company's specific industry or in prior entrepreneurial ventures. We also look at your team's passion for, and commitment to the new business idea, and your ability to inspire confidence among future stakeholders, including employees, potential customers, and investors. As we will be working together as partners, your team's credibility is essential. In addition, your team must be open to and comfortable with receiving input provided by angel investors.

Market opportunity.
We invest in solutions that address major problems for significantly large target markets (i.e. a $10+ million market). Your company must demonstrate a strategy to claim significant share of this market (i.e. 20%+). There are plenty of great

business ideas - but not all businesses will generate returns that justify angel investor and venture capital financing. Therefore, providing a solution to a problem with a large potential market is essential.

Use of proceeds.
Funds must be used to accelerate your company's achievement of key milestones that increase the company's value. We often fund activities that include research and product development, building a sales and marketing infrastructure and hiring key executives.

Growth potential.
We look for companies that can grow quickly and manage the scale necessary to succeed. Your company must demonstrate a plan to generate significant profits beyond the initial product idea. Do you have a strategy to achieve multiple sources of revenue? We also require well-conceived financial projections, based on sound assumptions, demonstrating consistent profits and cash flow growth.

Competitive advantage.
Your company must have some proprietary features that distinguish you from potential competitors or provide barriers to entry that prevent other companies from capturing your customers with a similar offering. Attributes that convey competitive advantage include intellectual property protection, exclusive licenses, exclusive marketing and distribution relationships, strong brands, scarce human resources (i.e. knowledge and skills), and access to scarce raw materials.

Fit.
Our group members - all accredited individual investors - have significant executive experience in a variety of fields. One of the benefits of working with angel investors is the active coaching and contact network that such investors can provide. As such, there must be a fit between members of our group and your idea.

Technology.
We prefer to invest in first-of-a-kind new ideas, rather than incremental enhancements to common products and services. Is this a nice-to-have, or a need-to-have product or service? However, we approach highly complex, esoteric technologies with caution. The concept behind the technology must be proven and verifiable. Further, we avoid science projects that don't demonstrate a clear path to commercialization. Any breakthrough innovation must be accompanied by a strong business plan.

Exit strategy.
Our members typically seek returns of at least ten times their initial investment, within 3-5 years. This level of return on investment is essential due to the high risk and likelihood of failure among early stage ventures. Thus, a clearly

articulated exit strategy - how angel investors will extract such returns - is essential. For example, do you plan to sell the company to an established corporation in your industry? Or will your exit be through subsequent rounds of financing - venture capital or the public markets? Angel investors are not just interested in the strategy you select, but more importantly in the how - the operational strategy that shows specific steps you will take to achieve the exit.

Funding Process

Self-assessment.
Before submitting your business plan for our consideration, you must determine if angel capital - and specifically capital from our group - is right is for your company.

Online application.
Our business plan application is designed to extract the most important details about your business, so our internal review committee can decide if your company should: a) be invited for an initial screening presentation; b) be referred to one of our partners for help in evolving your business plan; or, c) be turned down as unlikely to receive funding from our members.

Screening meeting.
After reviewing your business plan, our internal committee will determine if your idea could be of interest to our members. If you succeed, you will be invited to present to the full membership. Be prepared to deliver a ten-minute investor presentation and answer questions posed by this group for an additional ten minutes.

Presentation to membership.
Following the screening meeting, you will be invited to present to our full membership. You will have the opportunity to elaborate on your business plan. Prepare to deliver a 30-minute presentation and address questions for an additional 15 minutes.

Due diligence.
During due diligence, interested investors will verify the statements made in your business plan, presentation, and financial projections. They will thoroughly research your team's background and track record. If you play an active role in facilitating this process, it will help to expedite a final investment decision.

Term sheet negotiation.
After successful completion of the due diligence process, interested angel group members will present a term sheet that defines the structure of the investment deal - including type of equity and board of director’s representation, using industry standard terms and provisions.

Funding & Beyond.
When all parties are satisfied with the terms and language contained in the term sheet, the deal can be executed. But remember, closing the deal is only the beginning of the angel funding process. Now you have access to a network of value-added contacts and experienced professionals who can provide essential guidance for the growth and success of your venture. Adhering to the responsibilities at this stage will enable you to get the most from your angel relationship.

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