INVESTOR READINESS

A guide for companies seeking venture capital funding

The founders and managers of early stage companies often have a very different perspective to potential investors. This guide aims to help entrepreneurs understand the venture capital (VC) point of view more clearly, and to think through all the things that are required to make their company more likely to attract investment and to succeed in the long term.

Companies at different stages of maturity will have made varying levels of progress in bringing together the elements outlined below. It's not necessary that all of the factors outlined are in place at the time of the investment, but only that the company shows awareness of its path, has a plan, and is thinking about what it needs to do in each area:

TEAM

- *Build the right team*
  Investors will appreciate a passionate and visionary core team that is both ambitious and pragmatic about the company they are building. The team should bring together complementary skill-sets including, leadership, technology, sales, and financial management. Different skills can be brought in at different points in a company's life. For example, sales people may not be needed until the product is nearing completion. In the early days, the founding team may play most of the roles themselves.

- *Bring in industry experience*
  It is invaluable to bring people on board who have direct experience and a track record, ideally in the same industry. For example, a sales recruit may have worked inside the company's customers and understand exactly how their procurement works.

- *Bring in serial entrepreneurs*
  Investors will highly value the involvement of previously successful entrepreneurs who have experienced taking a company all the way to exit. This involvement may be on the advisory board, as consultants, or as employees. Seasoned entrepreneurs 'speak the 'same language' as investors, and will be selective about the companies they work with. Their involvement in a growing company puts a stamp of approval on the firm.

- *Be prepared to cede control*
  The entrepreneur / founder may not be the best person to act as CEO of a company once it grows. Persuading the founder to cede control of a company to other managers is one of the hardest tasks for investors in a company. Investors will appreciate a founder who recognises that the long term success of their company may depend on bringing in an external CEO to take it to the next level of growth.

TECHNOLOGY

- *Build original, protectable technology*
  Investors prefer sound original technologies that provide the company with a competitive advantage unique in the marketplace. If a company is providing a service or bringing together existing technologies, then it should be clear about the unique capabilities or methodologies it is bringing to bear. Where does the value of the company lie? What is the proprietary capability that an acquirer would be willing to pay for?

- *Develop the technology through interaction with customers*
  Entrepreneurial success is not about the cleverness or ‘coolness’ of the technology, it is about the ability of the company to develop products that customers will pay for. Customer collaboration illustrates the closeness of the technology to the market, demonstrates demand, and allows the product roadmap to be informed by feedback from customers. Clearly, this kind of collaborative development can only take place in an environment of confidentiality and trust.

- *Plan the patenting process*
  A technology should be patentable and defensible. Patenting can be an expensive and time-consuming process. Get good early advice on the timing and process of patenting, ideally from someone who does not charge by the hour (of course, good lawyers should be brought in to the process at the right time).

MARKET

- *Reason through your projections*
  Growing businesses usually project an increasing market share in a massive market. Venture capitalists have seen this many times, and are likely to ask hard questions. What is the realistic addressable market for the specific product? Have the team thought about the way in which they will be able to gain the projected market share? The company can start by showing the addressable market for their first product, and then talk of larger markets that it will address with its future product roadmap.

- *Consider broader market forces*
  Think about the broader environment within which your company operates. What are the Social, Legal, Economic, Political and Technical changes occurring in the market-place (SLEPT analysis). Are there factors and risks beyond your control? Can you take advantage of, or mitigate against, certain changes.

PRODUCT

- *Focus on the goal*
  It can be tempting to continue running a consulting business while the product is being developed, in order to fund product development and build relationships with customers. However, consulting can also distract management, and consulting businesses typically do not have the scalability or growth potential that venture capital investors seek. At some point, the company may need to become fully product focussed. In making this transition, a company may be able to turn consulting clients into technology development partners, channels to market, or customers for the product.

- *Manage the roadmap to phase your risks*
  You do not need the perfect full-featured product from day one. Start by developing something that is simpler and more achievable, allowing you to isolate risks and demonstrate working product earlier.

- *Fund product development from revenues*
  It may be worth selling an interim product because these initial revenues will finance and inform the development of the final product. Early revenues mean that a company has to turn to external sources of capital later and less often, allowing it to remain focussed on development.

- *Learn to explain your products from an outsiders perspective*
  Many entrepreneurs are so steeped in the technology that they forget to take a broader

view when explaining it to third parties. Think about the laddering of benefits: your company develops technologies, these technologies enable features in somebody's products, those features deliver benefits to end users. While technologies may require jargon and industry knowledge to explain, benefits can be explained in plain English to anyone.

CUSTOMERS

- *Build customer relationships early*
  Customers are absolutely central to a commercial proposition. It is important to build customer relationships relatively early in the game. Investors in 'A' and 'B' round financings will look for customer traction.

- *Consider all your target markets*
  Consider broadly the potential markets and customers that you wish to address. Think about the size and growth of the market, the competition, your ability gain access to that market, and its structural characteristics. Different customer groups may vary by volume of purchases, quality and features demanded, length of buying cycle, qualification requirements etc. For example, defence and government buyers may be slow, bureaucratic and have a long certification process, but they can be dependable high volume customers in the long term).

- *Find channels to market*
  It may be difficult for small companies in certain industries to approach customers directly, especially if customers are large firms with established supplier relationships. You may need to develop strategic alliances and partnerships with 'channels to market' - companies that already supply to your target customers. Ideally you should get the benefits of a channel partner without locking yourself into exclusive agreements with them.

- *Sell to build experiences and capability*
  Even a small volume of customer sales demonstrates to investors that the company has learned about the selling process from proposal through to negotiation, shipping, logistics, payment, collection and customer management. This is a step change in maturity from pure technology development and significantly decreases the risks of investment.

BUSINESS MODEL

- *Consider alternative business models*
  Think through the range of possible business models. Do you license technology, sell products or provide a service? Do you charge up-front or on an ongoing basis? Should you build a customer-facing brand or provide a white label service? Consider which strategies help you to get to market early, and which build long term value in the company. Think about which models are more scalable (i.e. that allow you to grow sales without a commensurate increase in costs).

- *Think globally*
  We live in a world of increasingly global markets. Some of the biggest I.T. buyers are in the U.S, while many advanced wireless buyers are in Europe. Manufacturing firms are looking to produce in China, while software development is being outsourced to India and elsewhere. Asia is a growing consumer market. Over the next decade, Indian and Chinese firms may increasingly acquire Western companies. Successful companies

will be globally competitive from the beginning, and will locate offices, capabilities and people where the best opportunities lie.

FINANCES

- *Be frugal*
  It is critical that an early stage company should have strong cash management. Companies that develop a culture of frugality are able to direct resources efficiently to those areas that are critical to future success. Some methods to conserve cash include leasing instead of buying, paying in equity instead of cash, and staggering payment schedules to suppliers so that upfront payments are lower. However, you should not promise to make back-payments to suppliers once funding comes through. This amounts to a debt on the balance sheet, and investors will be reluctant to pay for debts from the past.

- *Prepare for difficult times*
  Most successful venture funded companies have been through a 'near-death' experience at some point in their development, usually driven by a shortage of cash. At difficult times like this, a management team should be able to motivate employees, keep suppliers on board, hold creditors at bay, and generally convince external parties to give 'something for nothing'. Investors will appreciate entrepreneurs who show the determination and 'hunger for success' that will drive them through these difficult times.

- *Be ambitious*
  Frugality does not mean that a company should always be starved of cash. Companies should be ambitious enough to seek larger capital injections to speed development / scale rapidly if it enables them to capture high value opportunities where speed to market, rapid expansion or scale are important to success.

FUNDING

- *Build a clean investment structure*
  Investors will look for a clean structure in which to invest. Has the ownership structure been clearly defined? Has the company carried out other activities in the past? Has it accrued any debts / liabilities (including directors liabilities)? Was the intellectual property developed inside the company? Does anyone else have a potential claim to the intellectual property?

- *Do not underestimate the fundraising process*
  Raising capital from external sources is often a long drawn out process that diverts large amounts of management time. It is usually more difficult than originally anticipated (and the money is not secure until it is in your bank). A company should plan to approach external sources of capital only a few discrete number of times during its development, and should be sufficiently mature and capitalised to approach investors from a position of strength.

- *Understand the VC fund cycle*
  Venture capital firms raise their own funds, which they invest and reap over a fixed lifetime (typically 5-8 years). They finance new companies during the investment phase of this fund (typically the first 3-4 years). They have to return cash to their own investors at the end of the fund's life. If you encounter a VC firm towards the end of its investment phase, then it may be looking for mature companies that it can exit quickly.

- *Seek good investors*
  Good investors can provide knowledge, experience and relationships that are key to making a company successful. They can open doors with partners and customers, introduce experienced senior managers to the firm, and bring in other investors through their relationships. Most VCs claim to add value, but you will need to judge them based on your interactions and through references from other investees.

- *Know your investors' fund focus*
  Funds may seek to make diversified investments or may be focussed on a particular sector or geographical area. Find out when your potential investor raised their last fund, how big it was, and how many investments they have made. Are they actively investing? When was their last investment? Are there competing companies or potential synergies in their portfolio?

- *Expect dilution*
  Many early stage entrepreneurs do not appreciate the level of dilution that occurs across several rounds of funding. Building a successful company is a high risk business. Venture capital firms take equity because of the risk they are prepared to take on board. Successive rounds of investment can significantly dilute existing shareholders including earlier round VCs and founders. You can retain more equity if you ask for smaller amounts of funding, a fewer number of times, and later in the company's lifecycle.

VALUING A COMPANY

- Aside from revenue and profitability projections, investors will take a number of other factors into consideration when evaluating a proposition, including their faith in the team, belief in the technology, appropriateness of strategy, route to market, competitors, external factors etc.
- Notional ways of calculating the valuation of a company include discounted cash flow (DCF) projections and multiples from similar transactions in the industry. However, these theoretical valuations are easy to manipulate and highly sensitive to a number of subjective factors. Each party can 'spin' a valuation to suit its own purposes.
- The only true valuation of a company occurs when a third party puts money on the table to buy or invest in a company at an implied valuation. The valuation in a real transaction is whatever can be negotiated between the parties.

MILESTONES

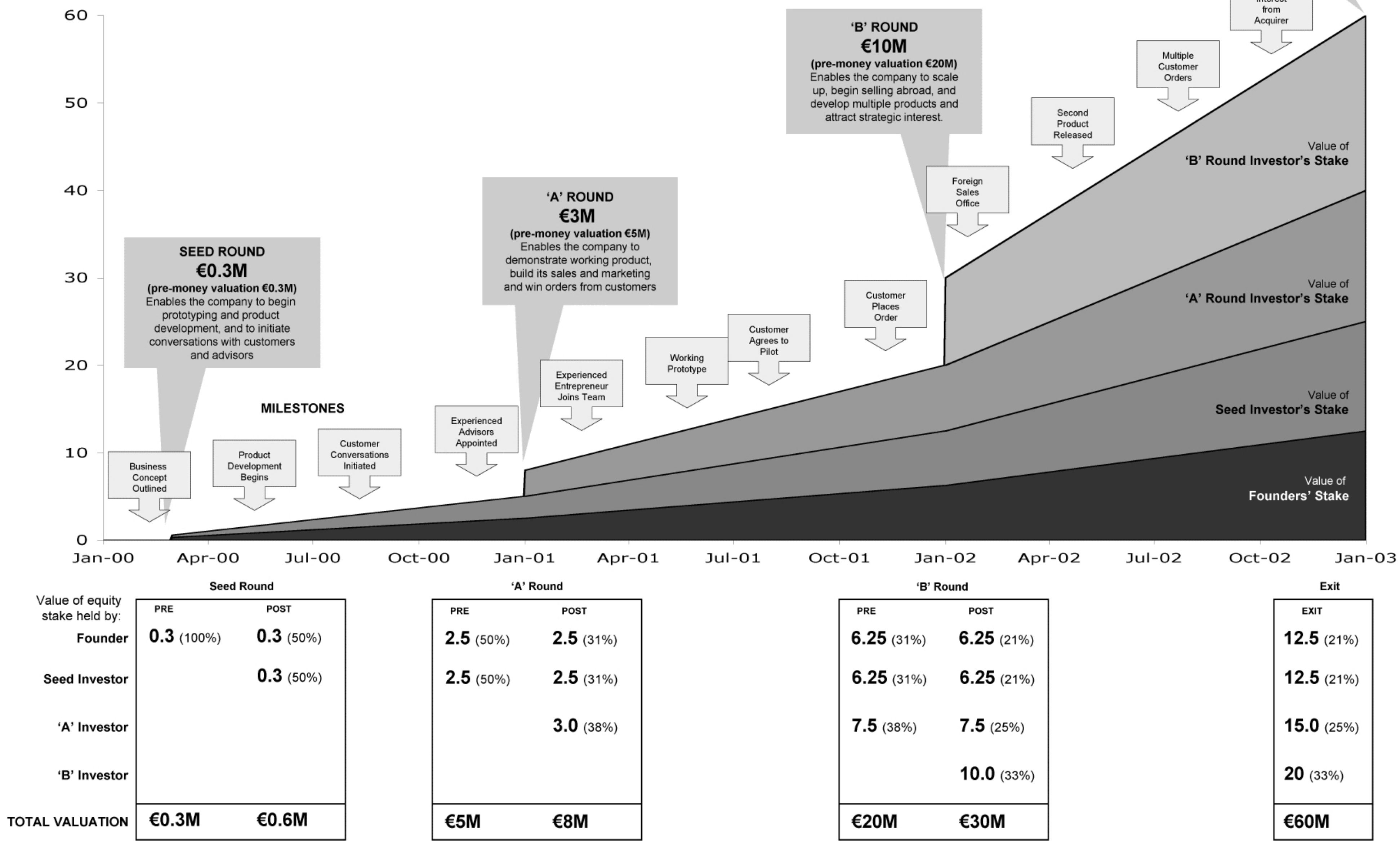
A simplistic way to look at how VCs see the value of a company changing over time is based on milestones – external indicators of how a company is developing.

Investors will look at the concrete milestones the company has already achieved, and will look ahead at the milestones they feel the company needs to achieve in order to become a success. Unachieved milestones represent risks – things that the company may fail to achieve and that may hold back the company's progress, lowering its value today.

For example, a company may feel that it is in discussions with a number of customers who are showing interest in the product. However, the VC has seen this a number of times, and on many occasions these discussions may have failed to lead to contracts. In the VCs mind, a significant milestone will have been achieved when one of those customers actually signs a contract and places the order. Until that point, there is a higher perceived risk. The perceived value of the company goes up when that milestone is achieved.

A great management team plans to achieve a series of milestones that are agreed with investors as the company develops. The team does not over promise – but it achieves the milestones it has set out with regularity. This builds confidence between the investor and the management team. The investor sees their value rising and their risk decreasing with the achievement of every milestone.

Example milestones include: "agreement signed with channel partner"; "customer signs joint development agreement"; "customer places order"; "experienced entrepreneur joins management team" etc.



Value of equity stake held by:	Seed Round PRE	Seed Round POST	'A' Round PRE	'A' Round POST	'B' Round PRE	'B' Round POST	Exit EXIT
Founder	0.3 (100%)	0.3 (50%)	2.5 (50%)	2.5 (31%)	6.25 (31%)	6.25 (21%)	12.5 (21%)
Seed Investor		0.3 (50%)	2.5 (50%)	2.5 (31%)	6.25 (31%)	6.25 (21%)	12.5 (21%)
'A' Investor				3.0 (38%)	7.5 (38%)	7.5 (25%)	15.0 (25%)
'B' Investor						10.0 (33%)	20 (33%)
TOTAL VALUATION	€0.3M	€0.6M	€5M	€8M	€20M	€30M	€60M

BUILDING VALUE OVER TIME

The chart on the previous page provides an example of how a company might build value as a result of the milestones it achieves along its path from concept through three funding rounds to exit. The chart also shows how the proportions owned by the various parties change, and how each investor gets their return.

Notes to the chart

- The chart is illustrative. The milestones are examples only. The numbers in this chart cannot necessarily be applied to other companies. The valuation of a company can go down as well as up.
- The chart shows a successful company. However, many of the companies in a typical VC portfolio will fail, with some falling to zero value.
- Money injected into the company in each round is shown in the chart as being provided upfront. In reality, investors may tranche their investments and provide funds to the firm upon achievement of milestones over time.
- The value of the company is shown in the chart as rising smoothly in between successive funding rounds. In reality, the funding rounds are the only points at which the true value can be measured. In between, you could consider the value rising in steps as milestones are achieved.
- The chart shows a simple allocation of stock between founders and investors. In reality, stock will also be set aside for employee option pools, and shared with additional parties such as the board of advisors.

A SIMPLE COMPARISON BETWEEN DEBT AND EQUITY

PRIVATE EQUITY FINANCING	DEBT FINANCING
▪ A private equity investor (such as a venture capital firm) provides capital (money) in return for unlisted equity (shares). In other words, they end up owning a part of your company. ▪ If your company is very successful, all parties will gain significantly on their share of your firm. ▪ If your company falls in value or fails, the investor will get less money or nothing back. ▪ An equity investor will realise value only when they find an opportunity to sell their equity stake in your firm (typically through trade sale, private placement, or IPO). ▪ Venture capital investors are willing to fund companies with unproven technologies in unpredictable markets. In return for taking this risk, they will seek companies with a scaleable technology and high growth potential. VCs typically fund companies that find it difficult to get debt financing.	▪ A debt provider (such as a bank) provides capital in return for future repayments of the principal plus interest. ▪ If your company is very successful, the debt investor will gain only their capital plus interest, while you retain ownership of the value (and hence the upside) of your firm. ▪ If your company falls in value, a debt investor will continue to demand interest payments. If it fails, they will have a strong claim on the remaining assets of the firm. ▪ Providing debt is lower in risk than providing equity. A debt will often be securitised against assets. Debt providers are risk averse compared to private equity investors. ▪ Debt providers typically lend to companies that operate in a predictable market with proven business models. If you work with a new technology in an unproven market, and are unable to provide collateral against a loan, then you may find it difficult to get debt financing.

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