Chapter 1

Nothing Ventured, Nothing Gained: Venture Capital Basics

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In This Chapter

- Getting familiar with venture capital and venture capitalists
- Determining whether you have a venture company
- Seeing the whole venture capital process

If you're starting a new business, welcome to the club! Starting a business can be the most exciting, scary, enlightening venture that you embark on. If you've been running a business for a while and are just starting to look for money, you've come to the right place!

Venture capital is often misunderstood and feels like a big cloaked, black box to many people. In reality, venture capital is pretty easy to understand after you've been given the basics. Further, venture capitalists are more open about sharing information than people think. You just need to know where to look for the information.

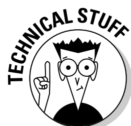
In this book, you discover which companies benefit most from venture capital, how venture capital works, how to connect with VCs, and when the time comes, how to pitch to investors. We also describe the whole start-up funding landscape and explain how to navigate it wisely. This chapter introduces you to venture capital and provides a general overview. Consider it your gateway to this exciting world.

Understanding Venture Capital and Venture Capitalists

Venture capital is a very specific type of investment for a very unique type of company. Venture capital–backed companies are expected to grow extremely fast — much faster than other companies. In addition, VC-backed companies

are sold after five or seven years in an acquisition or on the stock market in an initial public offering (IPO).

VC-backed companies have the potential to make millions (billions?) of dollars for investors and founders. Because of the huge windfall possibilities, a lot of people are interested in creating companies that are attractive to VCs. Nevertheless, venture capital is not a necessary part of building or growing your business. In fact, companies can do very well without venture capital and the involvement of venture capitalists.



Technically speaking, venture capital is just like any other investment, an asset class. Venture capital investments are high risk and also potentially high return. Not all investors want to be involved with venture capital (sometimes called *risk capital*) because of the level of risk involved.

The following sections introduce you to the venture capitalists — the people who invest the money in start-up businesses — and the kinds of companies that are prefect for venture capital.

Introducing venture capitalists

Venture capitalists are the professional investors who give start-up companies money in exchange for equity in the company. They provide both liquid capital and support for a company during a fundamental time in the growth of the business.

Venture capitalists are responsible for bringing together large amounts of money for an investment fund (called *raising a fund),* which is then used to invest in companies, hand-picked to become part of the VC's (or VC firm's) portfolio. The VC and his team choose companies that are capable of growing very large very fast, earning the VC firm many times its initial investment.

Venture capitalists know that not every company in their portfolio will produce a huge return on investment, and so to tip the hand in their favor, VCs do two things:

- They invest in companies that have excellent odds of being successful venture-quality companies.
- They support the companies in their portfolio with resources like mentorship, board members, and strong management.

Companies that work with venture capital give up an element of control in exchange for the opportunity. Most founders find the exchange worth it for the added capital, support, and connections that come with an investment of venture capital.

Knowing what VC firms look for

Venture capital firms tend to specialize. They focus on a specific stage of company and one or two industries. A VC firm may focus on companies in the medical device field, for example, or maybe in clean energy. Because VCs deal with risky investments, they have to make sure that they understand their chosen industry and technologies inside and out. Therefore, your company must fit into the firm's profile before the firm will consider investing. (You can usually find out which industries a VC firm invests in on the firm's website under the About Us tab.)

Focusing on different stages

VCs may invest in seed stage companies (companies with no revenue or little revenue) or stage 2 companies (those with $5 million to 50 million in revenue), or they may fund mergers and acquisitions of larger companies. Companies of different sizes have very different issues and needs. For more on the different fundraising rounds, head to Chapter 9.

Focusing on specific industries

Venture capitalists must be experts in their chosen industries, understanding it completely. This expertise is especially important because the best portfolio companies have game-changing technologies that disrupt markets. Predicting the success of companies that don't have any contemporaries is a very challenging task!

Focusing on the company's progress and potential

Most venture capitalists, even those who invest in seed stage companies, look for the following:

- That the company has a product or has made a lot of progress toward a product
- That the company has a strong team that can execute its plans
- That the company has connected with its target customer and understands its market

These factors impact your company's risk level. Investors have a level of risk that they are willing to accept in a company. Investors interested in later stage companies want you to have removed more of the risk from your company by progressing through necessary milestones. Seed stage investors are more accepting of risk and use a high risk profile as a way to get more equity for the same investment dollars.

Getting familiar with the VC fund lifecycle

Venture capital funds don't last forever. They tend to run on a predictable, ten-year cycle. To give you a better idea of your interactions with VCs, we've paired their activities with yours over the lifetime of the fund.

1. Investors spend the first year raising a fund from high-net-worth individuals (accredited investors), corporations, and institutional investors like pension funds. You aren't involved at this point. If it's a new firm and/or a new fund, you may not even know that the VC exists yet.
2. VCs spend the next few years finding companies to add to their portfolio (called *sourcing deals)*. During this period, you'll get introduced to a VC through a mutual contact, or you'll submit your pitch deck to the VC through the VC's website (find out more about pitch decks in Chapter 15.)
3. After the company is given investment and becomes part of the portfolio, the VC proceeds to manage the company. Generally, VCs do this by joining the board.

   VCs are very helpful to entrepreneurs throughout the investment relationship. They tend to act as the voice of experience in the relationship because they've been through company building many times. During this time, you'll be working hard to develop new products, increase revenue, and basically do what you do best — run your company.
4. As the fund nears the end of its lifespan, the VCs work to liquidate the companies through mergers and acquisitions. If the company does very well, it may go public and become a company traded on the open stock market. If the company isn't doing well, it can be shut down and its assets sold separately.

   It's the VCs job to sell your company to a buyer. It's your job to let him. This is how you cash out and take home the spoils of your hard labor.
5. As all the companies in the portfolio are sold, the money is returned to the original investors (limited partners) who entrusted their cash to the VC, and the VC fund closes. At this point, you're free to do whatever you want. Your formal relationship with the VC is over, and you can start a new company, get a 9-5 job in a corporation, or retire.

Choosing the Venture Capital Pathway

Companies that benefit most from venture capital are those that have a disruptive technology or product that they aim to grow very large very quickly. Entrepreneurs who benefit most from venture capital are those who want to create a great new company and do not need to retain full control over it as it grows.

Companies that have a tried-and-true product or service may not benefit from venture capital. Venture capital also may not be right for the company owner who likes to retain primary control or has always dreamed of handing the business down through generations. Chapter 3 is all about determining whether venture capital is right for your business.

When you work with venture capital, you make tradeoffs: You control less of the company and receive less of the total cash after your company sells. On the plus side, you have a support system of smart VCs, and your risk is distributed among more people.

Identifying a good venture business

Your traditional coffee house, clothing store, photography business, landscaping business, restaurant, real estate development company, and filmmaking company don't make sense as venture capital-backed companies. Different kinds of industry-specific investors put money into those types of companies.

Venture capital tends to invest in companies built around software, drug developments, medical devices, engineering devices, and other cutting edge technologies that are considered disruptive to current markets. (*Disruptive technologies* are innovations that could not have been predicted; therefore, their effect on the market as a whole cannot be predicted either.) VCs look for disruptive technologies because the potential for a huge return on investment is greater when the business hinges on very risky technology or market integration. High risk can equal high reward.

Of course, not all technology companies should be venture capital–backed companies. Many of technology companies would do well to grow organically — that is, without large investments of capital — and develop at a slower rate. Organically grown companies can be big winners, too. In fact, if you can get your company to profitability without taking outside investment, you may stand to make more money. Chapter 3 contains all the information you need to start deciding which track your company should take.

Looking at alternatives to venture capital

If you decide that the mega-high growth, high stress, venture-backed start-up company lifestyle isn't what you signed up for, you can grow your company as a small-to-midsized business (SMB). Compared to venture capital–backed companies, SMB companies tend to require a lot less capital, grow more slowly, and remain more stable as they grow.

Smalls business have lots of different ways to raise money, including through bank loans, crowdfunding, friends and family, grants, and franchising. Chapter 4 goes into detail about all your options as a business that ultimately chooses not to raise venture capital.

From Zero to Venture Capital: Knowing What to Do to Secure Venture Capital

The most successful venture capital businesses are not just good at what they do; they are also lucky. Because you can't do anything to improve your serendipity, you can plan your business from the beginning in ways that remove hurdles and increase the possibility of success. Follow these suggestions:

- **Start by thinking about the end.** When you look back on this business from the future, what do you want it to look like? Plan for the results that you envision. Chapter 8 tells you what your exit options are and explains how to prepare for your exit.
- **Target a huge problem that has a huge market.** VCs want big exits. The best thing that you can do to set your company up for VC funding is to go after a huge problem with a huge market. You can't sell a company for billions if it has an esoteric or limited market. Head to Chapter 6 to find out how to position your business to attract a VC's attention.
- **Get your feet under you.** VCs don't fund companies with grand ideas until the company shows a lot of progress toward revenue. This progress is often referred to using the word *traction*. Chapter 6 tells you what key components — business plan, product development, marketing strategies, and more — to focus as you prepare your business for venture capital.
- **Become visible.** You can increase the likelihood of getting funded quite a bit by simply meeting the funders. Make friends with investors. Get to know the VCs and the larger start-up community. *Schmoozing* isn't a bad word anymore. Chapter 5 has a number of suggestions for connecting with investors, both online and face-to-face.
- **Develop the deal.** Not only do you have to develop the company, but you also have to design a great investment deal. Investors like working with founders who know how to put their due diligence materials together and who have working knowledge of a term sheet. These concepts aren't rocket science, but getting familiar with the process does take time. Get cracking! And go to Chapter 9 for the details.
- **Start pitching.** After your company has gained traction, your deal is structured, and VCs know your name (or at least your face), you need to start pitching for investment. Pitching is such an important and involved task, that we dedicate an entire part to it: Part IV.

The following sections delve into more detail on three key points: getting your company ready, designing your investment deal, and approaching investors.

Preparing your company to attract interest

Just as you would prepare your home when you put it on the real estate market, you need to get your company prepared for investors: Gathering the right advisors, making sure your records and certificates are in order, planning your future growth, and really connecting with your customer are all important points when getting ready for investment.

Coinciding fundraising efforts around milestones

One of the hardest things to do in fundraising is to know when to start fundraising. The good news is that you don't have to decide on one particular, set-in-stone date. Instead, one way to ensure you have the funds you need when you need them is to time your fundraising between milestones. Identify all the major milestones that your company must tackle before you achieve profitability, and then plan your fundraising efforts to coincide with the period of time after you've just attained a pretty nice milestone and right before you tackle the next one. Your just-completed milestone will serve as a great story that shows your team's ability to execute.

Notice that this suggestion isn't "begin fundraising after you complete development of your whiz-bang product." You can — and should — begin fundraising rounds earlier than that. The key is to know your business, know your market potential, and be able to show progress toward your goals. Chapter 6 includes information about business plans, product development, promotion strategy, and communicating your future revenue streams before you ever earn a cent from your product. Head to Chapter 14 for a checklist to determine when you should start fundraising.

Polishing your company for investors

Get your company to a point where you feel comfortable having a figurative open house. Many companies are moving and developing so fast that they have ugly loose ends everywhere. You have to polish your company to raise money:

- Show your market research in ways that investors can follow. Raw data may be okay for you, but the investor is going to want to see well-designed graphs.
- Revise your business plan and business model regularly so they reflect the new information that you have learned since you originally wrote the documents. Write a two to three page executive summary for investors (they don't have time to read the whole thing).
- List all the strategic partnerships, mentors, advisors, and other supportive relationships that you have made.
- Plan out employee needs in the near future and start talking to potential candidates even if you don't plan to hire for 12 months.

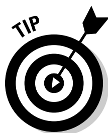
Chapter 6 has even more ways to get your company VC ready.

Connecting with customers early

Many companies think that they cannot begin to connect with customers until they have a finished product to sell. Nothing is farther from the truth. You can, and should, be connecting with targeted groups of customers as you develop your product. By the time the product is finished, you will have a small group of happy customers whose excitement you can leverage to promote sales. It's never too early to talk to a potential customer.

Adding expertise to your business

The number of people excited about your company can be indicative of future success, and VCs like to see lots of high-quality people who are willing to put their names on your company.

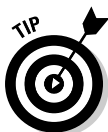


You can really increase your credibility with VCs by adding expertise to your team in terms of an advisory board or through strong mentors. Don't think you have to pay a ton of employees to have a big team! Chapter 7 is all about relationships and tells you how to get people involved in your company and your deal in many different ways.

Putting together the deal

Developing your business is only one part of raising capital. You have to develop the deal, too. Basically, the deal is the amount of money that you need and the percentage of the company that the investor will get in return for capital under certain conditions. Conditions can include requirements for milestone achievement, involvement of certain industry experts, or many other things. Chapter 9 discusses the deal in detail; following are some key points.

- **Lay out your company's plans for the future and determine how many times you'll have to raise capital to achieve your goals;** then coordinate your capital raises with big milestones (refer to the earlier section "Coinciding fundraising efforts around milestones"). Investors would much rather invest when they know a large milestone will be attainable with the capital raised. Matching capital to milestones is akin to raising enough money to put a person through a four-year degree. Nobody wants to invest in something that only gets the job three-quarters of the way done.



Companies raise venture capital after early rounds of angel capital, friends and family investments, or bootstrapping the company for a while. In Chapter 9, you can see what a normal funding pathway looks like. You also find information about the term sheet, differences between equity and convertible debt, and how to avoid pitfalls in early round deal structure.

- **Identify risks/milestone:** In this book, we use the term *risk* to mean the things that absolutely must go well; otherwise, you cannot achieve your goals. You can communicate the stage of your company, determine the price of your shares, and prove traction all by thoroughly understanding the risks you have overcome and the ones you still have ahead of you. Chapter 10 explores risk and tells you how to use the risks you face as a roadmap to success.
- **Calculate valuation:** After you have a grasp of risk, you can determine the valuation of your company. Chapter 11 defines multiple ways to calculate valuation and a few ways to discuss the topic with your VC without scaring him or her away!
- **Be prepared to negotiate:** To negotiate well, you have to understand what you want out of your deal. "A lot of cash" isn't specific enough. Use Chapter 12 to get into the mindset of negotiation. Identify what's important and what can be ignored when you go to the table.
- **Collect due diligence materials:** One of the best things you can do to help speed along your funding timeline is to get all of your business materials in order for due diligence. Doing so before an investor has shown direct interest may seem premature, but it's really important. Chapter 13 includes a checklist of materials.

Gathering due diligence materials can be a fairly extensive process tat takes weeks to complete. If weeks pass *after* an investor expresses interest in your company, you can lose momentum and subsequently, the deal. Being organized is key!

Making your pitch

In a pitch, you present your company and your deal to investors. These days, the standard way to get money from VCs is to pitch to them using a PowerPoint presentation and a short dialog. The general pitch will go something like this:

1. **You tell investors what you do (software, hardware, device, toy, or business tool, for example) and how you'll make money.**
2. **You discuss just how much money you can make by describing the people or businesses who'll buy this product.**
3. **You tell investors how you will gain access to your customer by detailing the promotional plan and the distribution plan.**
4. **You tell investors about the milestones involved in your company's future development and reassure them that you are capable of running this company by outlining all the milestones that you've already overcome.**
5. **You give financials (these must make sense) and then talk about the investment opportunity.**

Notice anything about this sequence of discussion topics? They all focus on money. If an investor pitch has a theme, that theme is money. You'll talk about your product and how it solves a problem for someone; you'll discuss the market and the investment; but the whole time, you're really talking about money. Head to Chapters 14, 15, and 16 for the details on making your pitch.

Following a few unspoken rules

There's quite a bit of information that you convey nonverbally during a pitch. These unspoken signals are the cues that VCs use to determine whether you're "in the know" about venture capital and how to grow a company. To a VC, working with a founder in the know means that he doesn't have to spend the next three years teaching you how to work with him. Some clues that you're in the know include the following (all of which you'll know after you finish this book):

- **Speaking the language.** It may seem superficial at first, but if you know what a *term sheet* is (Chapter 9), what a *down round* is (Chapter 9), and why an exit is important (Chapter 8), then you are on your way.
- **Understanding the VC's motivations.** It's easiest to do business with someone who understands what you need from the relationship. Find out about this in Chapter 2.
- **Being communicative.** Things aren't always perfect. A VC wants to work with someone who is a forthright partner that can be trusted to share all information in a timely manner.

Most business transactions occur between people who feel like they have a rapport with one another. Before you can ever close the deal, you have to really connect with your investors. Chapter 7 explains how to cultivate relationships with the people you'll come in contact with during your venture adventure.

Planning to do it again!

Fundraising is a process. If you are successful and able to raise money, you will likely raise money again in the future. Fundraising skills are always powerful to have in your back pocket. In addition, the more you pitch, the better and better you get. When a pitch is done well, it's obvious to everyone in the room. Practice your pitch over and over and remember that it can always improve a little more!