Key Steps Before Talking to Venture Capitalists

Some entrepreneurs may not be familiar with raising institutional capital to grow their businesses. Expansion plans beyond common organic growth are typically dependent on personal investments from company founders, friends, family, and occasionally from banks or the government.

Even in regions where it was once scarce, venture capital (VC) is becoming a more important option to raise new money – especially in high growth sectors such as technology. Unfortunately, many entrepreneurs do not know how to present an investment opportunity to institutional investors or what to expect from them aside from their financial investment.

Intel Capital, Intel's strategic investment program, is one of the largest global corporate venture programs investing in the technology segment. Its experience has shown that during the analysis and negotiation phases, entrepreneurs often have questions regarding the practices of Intel Capital and other potential co-investors.

In an effort to help explain this way of doing business, Intel Capital has put together a partial checklist as well as some explanatory discussion. While incomplete, this may help offer some guidance on the decisions and preparation prior to approaching investors with a proposal.

Key issues and steps in the investment process include the following:

- Raising capital with venture capital is about growing a business.
- Put yourself in the investor's shoes and criticize your own proposals.
- Know your audience.
- Prepare a business plan and an executive summary.
- Value your business and set your negotiating boundaries.
- It costs time and real money to raise capital.
- You will likely need experienced legal advice.
- Get ready for a road show.
- Be prepared to start the negotiation and open your company for external scrutiny.
- Be prepared for changes in governance.
- Understand the different roles of the entrepreneur, the CEO, and the shareholder.

Raising Capital with Venture Capital is about Growing a Business

There are many ways of raising money for new projects. While potentially expensive, banks are sometimes a good alternative for immediate needs. They may be able to lend the entrepreneur money if he or she has tangible guarantees to offer as collateral, such as fixed assets or receivables.

Venture capitalists are different. They are paid to run calculated risk with third party's money in high growth opportunities, companies that have a chance to multiply their size many times over as they succeed in the marketplace – and lead to attractive returns on the initial investment when a liquidity event occurs. They typically do not ask for guarantees, but will ask for protective provisions and the entrepreneur will have to share with them the guidance of the business. Do not expect free money because it typically comes with strings attached.

Put Yourself in the Investor's Shoes and Criticize Your own Proposals

Investors often have at least three key vectors in mind when selecting a proposal: a strong management team, a good company in a rapidly growing market segment, and a clear vision of the future. Expect to demonstrate at least these three elements before knocking at the doors of potential investors.

VCs are likely to ask several key questions. Are the existing stakeholders in sync? Does the team share the same vision for the growth of the company? Can they develop the required sales channels? Do they have a clear plan for accomplishing that? What do they need investors for? For what do they need money? The process requires that the entrepreneur carefully does the homework before asking for institutional money.

There are tools out there for answering some of the questions and it is generally a good idea if you try to solve them prior to talking to investors. There are plenty of information and reference guides on how to structure a business proposal. A simple search on the Internet can provide insightful information on business planning. Remember that investors are paid to analyze proposals on a day-to-day basis and chances are that similar projects will reach their hands. Why should anyone pick your plan instead of a more structured one?

Know Your Audience

Good business opportunities will always find investors. There are plenty of funds and individuals willing to invest in good financial opportunities. However, not all investors are alike. Investors vary depending on certain deal characteristics (i.e., size of the round, opportunity to assume control, executive position) and risk aversion (i.e., maturity of the company, market segment). This diversity comes in the form of friends and family money, angel investors, government seeds, early and later stage venture capitalists, and private equity firms.

They also vary depending on the typical interaction they have with their portfolio companies – even amongst VC firms. Some funds are extremely active and present in the day-by-day decisions of the companies, helping with networking, sales calls and financial decisions. Some other funds are very low touch, with minimum interference. Commonly, the latter tend to look at more evolved projects, where company building is not as much as an issue.

It is extremely important to know who the investors are and their profile. A good way of understanding the industry is looking for information in venture capital associations (non-profit organizations promoting entrepreneurship) and investor web sites. A random sample of links to such information is provided here:

http://www.nvca.org/
http://www.endeavor.org
http://www.michiganvca.org/
http://www.vcinstitute.org/
http://www.abcr-venture.com.br

Intel Capital

Intel Capital, Intel's strategic investment program, is one of the largest global corporate venture programs investing in the technology segment. Its mission is to make and manage financially attractive investments that support Intel’s strategic objectives.

With an overall strategy to stimulate advances in computing and communications, the Intel Capital team seeks out and invests in promising companies worldwide working together to establish new and innovative technologies, develop industry standard solutions, drive global Internet growth, enable new usage models, and advance the computing and communications platforms.

Intel Capital has dramatically expanded its non-U.S. investing over the past few years. International investing has increased from comprising less than five percent of Intel Capital's deals in 1998 to about 40 percent of deals in 2003. Of these non-U.S. investments, about half of them were in Asian and Japanese companies and the rest were in companies based in Eastern and Western Europe, Israel, and Latin America.

Intel Capital has invested in companies headquartered in more than 30 different countries on five continents. Key areas of investment worldwide include the mobile PC platform, the digital home, enterprise computing, cellular/handheld platforms, communications infrastructure, and manufacturing technology.

Prepare a Business Plan and an Executive Summary

The first step towards raising capital should be to establish a connection with a potential investor. Now that you have mapped the industry and know who would be interested in your proposal, contact them. It is a must to have an “executive summary” or a “teaser” on your company. Focus on highlighting the business, the market segment opportunity, and why you will succeed. This is typically a four-page-document (or less) that can be sent by e-mail and should not cover any confidential information.

The “executive summary” should be the first one or two pages in the business plan (BP). It gives guidance to the reader. A BP is where the company states its growth strategies (describes the management team, marketing strategies, product definitions, competition environment, investments going forward, cash requirements, etc.). It does not need to be 100 pages long, but has to be meaningful and clearly articulate your competitive advantage.

Fundamentally, you will be trying to explain the business opportunity, what is the solution you will bring to the market, how are you going to execute your strategy and why are you going to succeed. Tables, spreadsheets, charts and everything else can potentially help you present your case.

One of the most important pieces of your BP is the financial projection. Investors are looking for growth opportunities but do not try to simply inflate growth expectations because this can backfire on you. VCs commonly make their own projections, sensitizing your numbers – so present projections you are ready to bet on and defend them with facts.

A good way of assuring robustness in your plan is to build it bottoms up (from your resources up to the revenues) and challenging your results tops down (from the total addressable market segment to your segment share of it). This exercise provides a good reality check.

Business plans projections will be negotiated and will normally serve as a guiding post after the investment. The entrepreneur, as management, will be evaluated based on his or her performance against this budget.

Note that before receiving any confidential information, third parties often sign a non-disclosure or confidentiality agreement. You may wish to avoid providing your business plan to third parties before having these documents signed. It is important that you have your legal support in place for you to be comfortable with these documents.

Be prepared to discuss the following aspects of your proposal when talking to investors:

- Team: Explain your team, their background and working experience (relevant to the venture).
- Projections: Five year forecast, reasonably connected to your current businesses.
- Clients: Who are your current clients?
- Business Model: How do you sell and at what price points, what market segments are you targeting?
- Major Competition: Who are the main players in the segments you are targeting?
- Strategies & Tactics: Why you would succeed? What’s your differentiation?
- Use of Proceeds: Explain the use of the capital to be raised.
- Investors: Who are the other investors in the round?

Value Your Business and Set Your Negotiating Boundaries

The techniques investors use to value potential deals do not vary much. You should do your own homework and evaluate your business accordingly. This will avoid potentially endless negotiations with major gaps between your expectations and those of investors. In many cases investors will use comparables (companies in the same market segments) as a reference to value your business (market value of public companies, mergers and acquisitions occurred, etc.) and discounted cash flow projections. Naturally each investor will have its own risk factor to use as discount so try to take that into consideration. Define what would be your comfort zone.

There is a common misconception that asking for a very large valuation up-front will help you reach a mid-ground agreement. Many times this can fend off investors, as they might think the valuation gap is too big to reach an agreement. Set a price in which you believe and then defend it. Often, this valuation is already above that of the investor, because entrepreneur and financial investors have different perceptions of risk.

It Costs Time and Real Money to Raise Capital

Compared to the height of the Internet boom, investors now tend to spend much more time in the investigation process (talking to clients, doing background checks, visiting the target company, seeking for external references, etc.). A round tends to last roughly four months in the best case scenario and sometimes can take as long as one year.

Many investors have investment committees that have to approve the deal in different phases in order for the deal team to go ahead. It is common to find two approval instances; the first one normally takes place after the initial investigation is finished (typically before investors present a “term sheet”) and the second, after the negotiation process is concluded and final document drafts began circulating between parties. At any of the two committee review meetings (or during investigation), the deal may be discontinued.

Companies should be aware that usually all expenses that they incur in order to promote a round are not refunded. All legal, audit and other costs will typically occur at the company’s expenses. Transaction fees will often be charged to company as well (e.g. antitrust filling when required). However, if the transaction is not successful and the service providers were hired by the VCs, their costs will usually be at investors’ risk.

You Will Likely Need Experienced Legal Advice

Lawyers assist the entrepreneur by interacting with the legal representative of the potential investors. Your interaction with lawyers will increase exponentially as you evolve in the process of raising money. When hiring your own lawyer, it is important to ensure he or she has strong expertise in corporate law, preferably with previous venture capital transactions.

Professional counsel is also important to protect your intellectual property rights. Do your research and if possible negotiate a cap (limit) on the total hours they will bill you and try to get a deal upfront, therefore limiting your risk if the transaction does not occur. Sometimes investors already have a negotiated package with a law firm with whom they are comfortable, so consider this alternative as well.

Even though investors stress the importance of legal advice, business issues should be negotiated by the entrepreneur (e.g. valuation, equity rights, liquidation preferences, etc.). The document for this negotiation is the “term sheet.” The idea behind the term sheet is to put in simple wording all the rights and obligations of each of the parties involved in the transaction. Once you agree to all terms, the lawyer’s role is to make sure that what was agreed in the term sheet is reflected in the company’s by laws and in all investment documents. The term sheet is the guide to drafting the documents. Since it is a simplification, transaction documents will have further details on each right or obligation.

Get Ready for a Road Show

Now that raising capital is for real, get ready to hit the road. You will have to make presentations of your business plan, participate in meetings, and present the team that will execute the project with you. Remember, it is crucial that someone from the company take the lead of the fund raising process. Normally, one of the founders – acting as CEO – or a CFO must dedicate significant time to the process (in many cases, 100% of their available time is required). You will probably have to repeat your story a dozen times, but it will be worth your time. Always be objective. If you do not know something, do not hedge and simply say you do not know. Do not try to oversell your proposal.

Be Prepared to Start the Negotiation and Open Your Company for External Scrutiny

Equipped with your business plan and after some discussion, investors will present a term sheet stating the terms and conditions they would require in order to continue the process. Normally there is a time window in the term sheet for both sides to reach an agreement on its final version, after which it can be renewed or negotiation ends. It can sometimes require exclusivity from your side.

Once everyone agrees on the terms and conditions, then the due diligence process begins. You will significantly speed up the process if you organize the most relevant contracts and update all legal and tax documentation. Many companies create a due diligence book, with a copy of the required documentation to present to investors when asked for it, which exhibits a nice touch of professionalism. Sometimes independent auditors and lawyers will be hired – often at the company’s expense – in order to evaluate all company potential liabilities (regarding labor, taxes, etc.). The outcome of the analysis will usually be incorporated into the negotiations in order to limit the impact of past, present and future liabilities to existing investors.

Be Prepared for Changes in Governance

If this is your first move towards sharing the ownership of your company, realize investors will often require strong changes in governance and transparency – even if you maintain the majority of the shares. The founder(s) now work for the shareholders, not only for themselves.

Investors look for a balanced Board of Directors where their opinions can be voiced and heard. They will ask for board seats and establish some kind of supermajority – qualified quorum – for approving critical decisions and/or require veto rights over some matters. The rationale behind it is to preserve the investment from changes in company's strategies that have no consensus at board level. Remember you have presented a business plan somewhere in the past that all investors approved and decided to fund.

Understand the Different Roles of the Entrepreneur, the CEO, and the Shareholder

There are important differences between the characteristics of an entrepreneur and founder and the CEO running a business. It might be hard to notice this early on, but as time goes by, decisions will probably become less "impulsive" to become more structured and demand commitment from different stakeholders.

Traditionally, good entrepreneurs are very fast in taking decisions and somehow tend to centralize command in their own hands. This will definitely be crucial in the very early stages of a business, but as company matures, it might jeopardize the growth of a sound company. A time will come when a CEO is required to run the business in coordination with directors, responding to the board. It is customary that at some time during the life of a company, the founder(s) will step down from managerial position. In such cases, founders stay involved in strategic decisions through the board of directors and delegate the day-to-day business to a professional management team.

Also as important is to understand that the shareholders usually have the same interests in growing a business, but they are and should be less engaged in the day-by-day routines of the company. They have to give executive management the necessary freedom and authority to execute the business plan. Entrepreneurs need to ask themselves which role they would like to play.

One final point: Fund raising is only the beginning – a means to an end. The objective is to develop and explore a business opportunity that will hopefully create significant value to all stakeholders. Money is only part of the formula. Creating a team that shares the same vision and effectively works towards that vision is critical. This is valid not only for the employees, but also when deciding who to ask money for. Make sure investors share the same vision and values, and can really help in building your company.

Visit www.intel.com/capital to learn more about Intel Capital and its investments.