Guide to

Venture Capital

Madison Park Group

Innovation & Growth

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This guide will help senior executives, entrepreneurs and directors understand their options for raising venture capital. Some of the questions that are answered inside include:

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OVERVIEW OF THE VC FUNDRAISING PROCESS

Venture capital firms can be a very attractive source of capital for accelerating growth. However, there are many misconceptions about venture capital that make otherwise qualified firms unsure about pursuing VC financing. The reality is that qualified firms can readily access venture capital funds in a timely manner, often at very attractive valuations. This guide is intended to help founders and senior managers of technology, business services, and digital media companies determine whether venture capital is right for their respective organizations.

WHAT IS VENTURE CAPITAL?

Venture capital is equity financing provided by institutional investors that either manage a fund on behalf of large institutions (usually pension funds and insurance companies) or have their own proprietary pool of capital. Venture capital is raised in a series of stages or rounds. Venture capital investors usually specialize in one specific investment stage. Each stage also has its own unique set of parameters with respect to the:

- Operational progress that a potential investment needs to demonstrate
- Amount of capital a fund might invest in a given venture
- Investment time horizon (i.e., how long before the investor expects to get its money back)
- Investor return expectations (i.e., how much of the company will the investor expect to satisfy their return requirements)

WHO SHOULD CONSIDER RAISING VENTURE CAPITAL?

Many companies can benefit from raising venture capital since additional financial resources can accelerate growth and provide a competitive advantage in the market. For early stage technology companies that have negative cash flow, venture capital is often the only form of financing that may be available; other forms of financing such as bank loans are available only to companies with substantial physical assets or a long track record of positive cash flow. Even profitable firms can significantly benefit from venture capital as a means of accelerating growth plans, funding acquisitions, entering new markets, or launching new products and services as well as providing shareholder liquidity.

The challenge for entrepreneurs is to match their company's stage of development and business prospects with the appropriate venture capital sources. Entrepreneurs for early stage companies without prior experience in raising venture capital should leverage advisors with strong ties to angel groups and early stage venture capital firms in the firm's local area. Companies seeking later stages of venture capital, regardless of experience, should consider hiring an investment bank with contacts nationwide to manage the fundraising process and create a competitive bidding environment.

WHAT ARE THE STAGES OF VENTURE CAPITAL INVESTMENT?

There are five distinct stages of venture capital funding: start-up stage, seed or early stage, growth stage, late stage, and buyouts/recapitalizations.

Angels or VCs?

Increasingly, angel investors and seed stage VC funds are competing with each other for investments in the $500K – $2 million range. Each brings something different to a start-up. An angel with strong operational expertise in a start-up's industry can often relate better to entrepreneurs and offer mentorship, more patient capital, and better valuations. Angels, however, can be eccentric and may not gauge market trends as well as VCs. Seed stage funds can often provide follow-on capital, which angels often cannot. Also, firms that need additional financing rounds will find subsequent fundraising efforts easier if its business concept has already attracted an institutional investor.

U.S. VC Funds Getting Bigger

According to Thompson Reuters, U.S. venture capital firms raised $37 bn in 2007 vs. $31 bn in 2006. The average size of the funds raised in 2007 was $111 mm vs. $106 mm.

START-UP STAGE

Newly formed companies without significant operating histories are considered to be in the start-up stage. Most entrepreneurs fund this stage of a company's development with their own funds as well as investments from angel investors. Angels are wealthy individuals, friends, or family members that personally invest in a company. Angels are the most common source of first round funding for technology businesses and angel rounds usually less that $1 million. They often will back companies that are at the concept stage and have a limited track record with respect to customers and revenue. These investors tend to invest only in local companies or for people that they already know personally.

SEED OR EARLY STAGE

Seed or early stage rounds often involve investments of less than $5 million for companies that have promising concepts validated by key customers but have not yet achieved cash flow break-even. Organized groups of angel investors as well as early stage venture capital funds usually provide these types of investments. Typically, seed and early venture capital funds will not invest in companies outside their geographic area (usually 100-150 miles from the VC's office) as they often actively work with management on a variety of operational issues.

GROWTH STAGE

Growth stage investments focus on companies that have a proven business model and either are already profitable or offer a clear path to sustainable profitability. These investments tend to be in the $5-20 million range and are intended to help the company increase its market penetration significantly. The pool of potential venture capital investors is very robust for growth stage investments, with firms across the United States willing to participate in investment rounds at this stage.

LATE STAGE

Late stage venture capital investments tend to be for relatively mature, profitable companies seeking to raise $10+ million for significant strategic initiatives (i.e. investment in sales & marketing, expansion overseas, major infrastructure build-outs, strategic acquisitions, etc.) that will create major advantages over their competition. These opportunities are usually funded by syndicates of well-established venture capital firms who manage large funds.

BUYOUTS AND RECAPITALIZATIONS

Buyouts and recapitalizations are becoming more prevalent for mature technology companies that are stable and profitable. In these transactions, existing shareholders sell some or all of their shares to a venture capital firm in return for cash. These venture capital firms may also provide additional capital to fuel growth in conjunction with an exit for some or all of the company's existing shareholders.

WHY RAISE VENTURE CAPITAL IF MY COMPANY IS ALREADY PROFITABLE?

A large portion of an entrepreneur's personal wealth is usually his/her stake in the entrepreneur's company. It is in the entrepreneur's own best interest to grow this equity stake as large as possible as quickly as possible. Even if the company is profitable, its resources are constrained by the profits generated by the firm. In competitive industries, a large financial war chest can not only speed the market penetration of a firm but also deter other companies from competing directly with it. Profitable companies with strong growth prospects can often raise 5x-10x their annual profits in new venture financing in return for only a minority stake in the company. Venture capital firms are willing to invest on this basis for firms that have the potential to grow to double or more in value as result of additional financial resources. Using this approach to accelerate growth, entrepreneurs can increase the value of their equity stake without significant incremental risk.

WHEN IS THE RIGHT TIME FOR A FIRM TO RAISE VENTURE CAPITAL?

Venture capitalists like to invest in companies with positive momentum. Momentum can be generated by new product launches, new customers or partners, increased market penetration, the hiring of well-respected executives or advisors, strong financial growth, crossing significant operational milestones, or any combination thereof. A company that has demonstrated consistent positive momentum over time is likely to be well-received by venture capital firms, even if the company lacks some of the key elements that venture capital firms typically seek such as intellectual property protection, significant contractual or structural barriers to entry, market potential of $500+ million, or other traits. Positive momentum builds confidence that a management team has not only identified a true market opportunity but also has the determination and wherewithal to capitalize on it. Companies should bear the following in mind as they consider when to begin the fundraising process:

- Fundraising is frequently a six month process or longer (although an investment banker can shorten this timeline to 3-5 months)
- Venture capital firms give significant credit for accomplished tasks and proven strategies and less credit for expected accomplishments or unproven strategic plans
- Providing additional "good news" to venture capital firms during the fundraising process adds credibility
- Raising capital becomes increasingly difficult as a firm's cash position deteriorates

A company should actively consider accessing the venture capital market as soon as a string of positive developments appears imminent or the company's cash balance is only sufficient to fund operations for one year based on current monthly cash burn rates.

Speed Matters

Venture capital firms are obsessed with the pace of development for their investments. Being fast to market with a product means receiving customer feedback sooner, building key relationships faster, and validating the market earlier. It also means defining a marketplace, deterring competitors, cherry-picking the industry's best customers, developing a market leading product, and amassing a large war chest of resources through market leadership. VC funds prefer teams that take this approach, viewing such a mentality as indicative of a results oriented firm.

Capital Trap

Entrepreneurs can create a capital trap by being too conservative. A capital trap comes about by only funding a firm in a growth industry via internal resources. This conservative fiscal strategy is best applied to mature industries, but is sometimes misguidedly applied to early stage and high growth markets, when capturing market share is initially more valuable than profits. By starving a firm for resources when a market's competitive landscape is rapidly evolving, management not only foregoes the chance to be a market leader but also can cost shareholders millions in lost growth opportunities.

WHAT IF MY FIRM HAS HAD SOME NEGATIVE EVENTS OCCUR RECENTLY?

Negative results happen and venture capital firms understand this. Venture capital firms will be looking to understand (a) the root cause of the negative results, and (b) how damaging was the negative result in the context of the firm's overall business prospects. If the firm has significant structural or intellectual property protections, strategic or management mistakes are more easily tolerated. For industries that offer few such protections, management mistakes are perceived as more damaging since much of the firm's viability rests on the management team's execution capabilities. In either case, the ability of management to make an honest assessment of the situation and take swift corrective action is critical to re-establishing credibility. The more traction the company can show toward a turnaround, the better. Negative results caused by external factors are more difficult to correct; they call the company's entire business model into question and can be fatal if an appropriate strategic response is not implemented. In these cases, a substantial amount of time might be necessary to re-orient the firm's business to a profitable strategy and right-size the company as required.

IP, VCs, and Entry Barriers

Barriers to entry are central to the investment theses of many VCs. Barriers to entry can be based on intellectual property (i.e., patents) or on operational features such as contracts, licenses, or capital requirements. VCs like IP based barriers to entry because they add value to technology firms independent of their operations. In sectors like business services and digital media where the ability to develop entry barriers based on IP is limited, it is critical that teams demonstrate speed-to-market, operational expertise, and a strong track record to VC firms.

Talk to VCs at the Right Time

Teams pitching VCs are often asked to return once a given milestone is met, indicating that the firm is too unproven. Some VCs do this to test a team's ability to perform. Others use this response as an artifice to say "no" without saying "no." Credibility will be lost if a firm falls short of the VC's milestone, but achieving it only gets the firm another meeting; it does not improve the chances of an investment. To avoid spoiling its investor base with these no-win propositions, firms should only approach VCs appropriate for their current stage of development.

WHAT IS THE PROCESS FOR RAISING VENTURE CAPITAL?

To raise venture capital, a company needs to prepare the appropriate documents, develop a targeted list of venture capital firms, schedule meetings with investors, and negotiate term sheets and closing documents. Firms begin the process by preparing a detailed business plan or investment memorandum, a thoughtful set of financial projections, a management presentation, and a due diligence package. Once the documents have been developed, the company needs to identify the venture capital firms that not only invest in similar stage firms as the company but also invest in firms in similar industries. Because they are usually flooded with requests from entrepreneurs, most venture capital firms accept meetings by referral only. Chances of getting a meeting via an "over-the-transom" contact are low, unless the opportunity clearly is the right stage and industry for the venture capital firm.

Through personal contacts, referrals, or an investment bank, the company and its advisors attempt to set up initial meetings with potential investors, usually at the investors' offices or via web meetings. Successful first round meetings will lead to longer second round meetings, usually at the company's main location. Depending on the quality and content of the due diligence package, additional due diligence trips may be made by the venture capital firm. If the venture capital firm would like to make a formal offer to invest, it will provide a preliminary term sheet outlining the general business terms for the investment. The company, its advisors, and the venture capital firm negotiate and execute the term sheet. This usually provides for funding of the investment subject to a more exhaustive due diligence review period of 30-60 days. Significant time and effort can be saved and substantially more venture capital firms can be contacted by using an investment bank to manage the fundraising process.

WHAT IS THE TIME COMMITMENT REQUIRED FOR RAISING VENTURE CAPITAL?

Venture capital fundraising requires a timetable of six months or more (especially if the fundraising is not being managed by an investment bank) assuming no negative events occur during the process. The CEO and CFO of a company should expect to be highly engaged during this entire process (30 or more hours per week), with some other managers involved on an as-needed basis, if a firm attempts to run this process themselves. Using an investment banker can cut management's time commitment roughly in half and can compress the overall timetable to 3-5 months.

HOW WILL RAISING VENTURE CAPITAL IMPACT MY FIRM'S EXISTING INVESTORS?

Venture capital investments will cause ownership dilution to existing shareholders. The amount of dilution is a function of both the amount of venture capital raised and the pre-investment (also called pre-money) valuation of the firm. Shareholders suffer less dilution as pre-money valuations increase and/or investment rounds decrease. However, even though existing shareholders may be diluted, the anticipated growth that comes from additional financial resources should more than offset any diminished ownership percentage.

Adding institutional shareholders to a firm's ownership group will also mean that a plan must be developed for the venture capital firm to sell its shares. The method and timing of the exit strategy must be coordinated with existing shareholders. Understanding the liquidity expectations and needs of existing shareholders before seeking a venture capital investment can prevent future disputes between various shareholder groups.

Dilution and Value Creation

Consider this example of the interplay between dilution and value creation: A firm with $4 mm of revenues is valued at 2.5x revenues and projects 50% revenue growth in each of the next two years, implying that it is worth $10 mm today and $22.5 mm in two years. A VC offers to invest $5 mm for a 33% stake so that revenues can grow by 100% per year. This implies a value of $40 mm in two years with existing shareholders' stake worth $26.7 mm. With the VC offer, shareholders gain $4.2 mm of value despite being diluted by 33%.

Articulate an Exit Strategy

Investors are concerned with both the method and timetable for returning their capital. Firms need to monitor shareholder sentiment closely, as their willingness to support long term strategies may be impacted by short term desires for liquidity and/or willingness to accept further dilution. Many options for achieving shareholder liquidity exist, ranging from an outright sale of the firm to targeted approaches for select shareholders such as recapitalizations or IPOs. A clear plan detailing the means and timing for providing investor liquidity can foster on-going investor support.

WHAT DIFFERENT TYPES OF VENTURE CAPITAL SOURCES ARE THERE?

There are five tiers of venture capital sources: angel investors, seed or early stage funds, growth stage funds, late stage funds, and private equity/leveraged buyout funds.

ANGEL INVESTORS

Angel investors are wealthy individuals who provide capital to fund concepts or very young companies that need to complete prototypes or attract initial customers. They typically invest less than $1 million per round and generally have long investment time horizons, often expecting to see their investment capital returned to them in a span of around 10 years. Angels typically are less concerned with the initial valuation of a company and are more concerned with establishing a firm's viability and its potential to be a profitable firm on a large scale. Generally, angel investors want to invest in businesses operating in industries that they personally know well. Some angels like to be highly involved in a firm's management, while others will be mainly passive. Angels often invest alongside other similar investors either through formal angel groups or through informal networks of similar individual investors.

SEED OR EARLY STAGE FUNDS

Seed and early stage venture capital funds typically have less than $200 million of capital under management and like to invest $1-$5 million in a particular company over several financing rounds. These funds tend to invest in companies that have at least built a working beta version of their main product or service and have a few trial customers using it. Seed and early stage funds tend to be fairly "hands-on" with their investments and actively seek to fill gaps in the company's management team and business strategy. These funds usually expect to have a shareholder liquidity event within 5-7 years. As with angel investors, early stage venture capital firms want to be within 100-150 miles of their investments so that they can more closely provide management assistance.

VC's Have Bosses, Too

Venture capital firms compete vigorously for capital provided by pension funds, insurance companies, and other financial institutions based on their ability to generate investment returns. Maintaining a stellar investment track record is essential for a VC firm to be able to attract the additional capital needed to remain operational. VC funds need to provide an annual rate of return of 20% – 25% over 5-10 years. If it underperforms, a fund won't attract additional capital and will need to shut down after its initial capital allocation is exhausted.

Corporate VC Investors

In between VC funds and strategic buyers are the venture funds of major global companies. Corporate VCs often have differing investment criteria from traditional VCs. Typically these groups make investments that might fill a gap in the firm's technology, product, or geographic portfolio. They often offer attractive valuations and access to potential customers. However, such investors also can deter other partners and limit a firm's exit alternatives. Some corporate VCs, though, invest like traditional VCs and place few restrictions on portfolio companies.

GROWTH STAGE FUNDS

Growth stage funds usually invest in rounds of $5-$20 million for companies with proven business operations that need capital to accelerate market penetration. These funds usually have $200+ million under management. Growth stage funds do not frequently take an active role in the management of a company, although they usually have a significant role on a firm's board of directors. These venture capital funds are national in scope and are willing to invest in businesses anywhere in North America and occasionally abroad.

LATE STAGE FUNDS

Late stage funds invest $20 million or more in mature, well-developed companies that seek significant expansion capital or operational cushion. These companies are typically profitable and address large markets. Late stage funds often have more than $1 billion under management.

PRIVATE EQUITY AND LEVERAGED BUYOUT FUNDS

Unlike the funds discussed above, private equity funds (also referred to as leveraged buyout or LBO funds) primarily buy existing shares in companies rather than invest in new shares. LBO funds are an attractive means for shareholders to monetize their stockholdings, especially if a company is not considering selling its shares in an IPO. An LBO firm may have as little as $200 million under management or may be as large as $10+ billion. LBO funds invest in companies of all sizes although a key consideration is profitability; LBO funds rarely invest in businesses that do not generate substantial positive cash flow. Typically an LBO firm will seek to acquire a majority position in a company, but occasionally these funds will consider minority positions if a firm is large or is in a highly attractive market.

HOW DOES A VENTURE CAPITAL FIRM OPERATE?

Venture capital firms make money by investing in newly issued shares of promising firms and selling their investments after a holding period of several years. Venture capital firms act as the general partner of a fund that invests capital on behalf of major financial institutions who are the fund's limited partners.

A venture capital firm typically charges its limited partners an annual management fee of 2.0% of assets managed and also retains 20% of the profits gained from investing the fund's assets and returns the remaining 80% of the profits to the fund's limited partners. A fund often has a charter that dictates the types of investments the venture capital firm may make with the fund's assets, usually placing restrictions on the types of industries, stage of company development, and form of securities in which the fund may invest. A fund also has a schedule for returning capital to its limited partners, usually starting 7-10 years after the fund was formed. As such, a fund that is relatively new tends to be most concerned with making new investments. A fund that is more than five years old is likely to be focused on exiting from its previous investments and is likely to have a fairly short investment time horizon on any new investments.

WILL A VENTURE CAPITAL FIRM INVEST IN A FIRM OUTSIDE ITS LOCAL AREA?

In general, venture capital firms will invest in companies outside their local areas if the business has a proven business model and no significant management gaps. If there is any uncertainty surrounding the business or management team, then it becomes significantly more difficult for a firm to attract an investment from an out-of-market venture capital firm. In such circumstances, a company is usually better served by first raising a smaller amount from locally-based venture capital sources and using the proceeds to refine its business model and management team before approaching out-of-area venture capital firms.

WILL A VENTURE CAPITAL FIRM BUY SHARES FROM ME AND/OR OTHER SHAREHOLDERS?

In many circumstances venture capital firms will provide liquidity to existing shareholders in conjunction with an investment in new shares. This usually occurs with firms that raise growth stage rounds and are profitable. In such instances, up to 30% of an investment round can be used to purchase shares from existing shareholders.

WHAT ARE THE KEY FACTORS THAT A VENTURE CAPITAL FIRM CONSIDERS WHEN MAKING AN INVESTMENT?

There are several interrelated factors that venture capital firms consider when investing in a company. In general, these factors represent trade-offs of market opportunity vs. operational risk. At earlier stages, investors may initially get intrigued by a firm's market opportunity but ultimately will focus on mitigating operational risk prior to investing. At later stages, venture capital firms focus more on capturing market opportunity as many of the operational risks common to early stage ventures will already have been addressed. Many venture capital firms develop internal investment theses around certain industry sectors and then seek out investments that support them. In general, a venture capital firm will define a market opportunity by its potential size, the market's barriers to entry, and the market development timeline. Sectors that offer large markets, high barriers to entry, and short market development timelines are usually preferred. There is interplay between these factors, though. A very large market without any barriers to entry that already exists today maybe be preferred over a smaller market with high barriers to entry that will develop sometime in the future. Or the opposite may hold true, depending on the individual venture capital firm's investment thesis and risk tolerance.

The Two Hour Drive Rule

Firms seeking angel, seed and early stage investments need to be aware of the "two hour drive rule." Because young firms often need hands-on assistance to move forward quickly, many early stage investors prefer to be able to make a visit without getting on an airplane, thus focusing on firms within a two hour drive of their offices. Young firms founded in locales with few early stage investors often move their operations to areas with higher concentrations of such investors just to have access to adequate growth capital.

VCs Like "Skin in the Game"

VC investors want founders to be financially committed to a firm. In addition to tying most of their personal wealth to the firm, founders are expected to hold their shares rather than sell them. Selling shares makes VCs wonder what management thinks about the firm's prospects. Founders must demonstrate compelling personal financial needs for a VC to purchase founders' shares. However, existing investors of profitable firms may find new VCs more willing to purchase their shares, depending on their own investment circumstances.

In addition to a venture capital firm's assessment of the market opportunity, the operational risk inherent in a particular venture is assessed thoroughly. Some forms of operational risk are inherent to a company's business model while others are directly linked to a management team's ability to execute. Some common areas that are scrutinized by venture capital firms are:

- Simplicity, scalability, and predictability of the business model
- Intellectual property and regulatory protections
- Duration, quality, and cost of new product development
- Stability and profitability of price points
- Value proposition to customers
- Customers' alternatives and substitutes
- Duration of sales cycle
- Customer switching costs
- Generation of repeat sales or recurring revenues
- Recruitment and retention of quality employees
- Credibility, cohesion and completeness of the management team
- Ability to reliably forecast future results and resource needs
- Cost and cash management skills
- Presentation and selling skills of the management team
- Personal commitment of key personnel to the firm

The management team of any company will need to demonstrate the soundness of its business model. Teams without significant direct industry experience will also need to prove to venture capital firms that they can reliably manage all of the aforementioned factors. As a consequence, experienced management teams with strong entrepreneurial track records often can raise larger sums at earlier stages of a firm's development than first-time entrepreneurs.

WILL A VENTURE CAPITAL FIRM STEAL MY IDEAS OR TAKE CONTROL OF MY COMPANY?

These are common misconceptions about venture capital firms. Venture capital firms are not interested in running businesses themselves nor do they look to build ventures around someone else's intellectual property. Doing such things gives a venture capital firm a bad reputation with both entrepreneurs and investors. The reputation of a venture capital firm is paramount to its long term viability and the overwhelming majority of firms act ethically and responsibly.

Entrepreneurs in very early stage companies, however, should realize that most business concepts are often not truly unique. In very hot market segments, a venture capital firm is likely to see multiple opportunities that are similar in nature over the span of a few months. Venture capital firms will evaluate these opportunities to find the most credible management team and invest in them. Very rarely are these circumstances the result of a venture capital firm expropriating an idea; it is much more common that a more qualified management team approached the venture capital firm with a similar concept.

There are also times when an entrepreneur's performance forces a venture capital firm to take action in order to preserve its invested capital. These situations often occur when entrepreneurs have been very aggressive in forecasting a firm's capabilities in the hopes of securing venture capital. Managers that consistently and significantly under-perform with respect to the financial metrics and operational milestones on which a venture capital firm based its investment will lose credibility and will be subject to scrutiny. In such circumstances, venture capital firms will do whatever is necessary to ensure that its investment can be salvaged including replacing managers. Usually such situations could have been avoided had the management team been more realistic regarding the company's prospects and the team's capabilities.

Niche Markets

VCs like firms with large market potential because large markets create a wide margin for error; capturing only a fraction of the market can lead to success. But some VCs will also invest in firms addressing niche markets (<$500 mm). Since niche markets offer less margin for error, a team's abilities are more closely scrutinized and more progress is required to secure funding. Creating barriers to entry is critical in niche markets, as competition can erode market share and margins to undesirable levels. Niche markets also have more limited exit options which may concern some VCs.

Competitors are Validation

Provided that they don't have insurmountable competitive advantages, competitors are actually helpful to a young firm seeking funding. Competitors, especially if they are VC-funded, validate the market potential for an industry. They also allow a firm to create points of differentiation. Venture capital firms view competitors as potential acquirers, giving portfolio companies a clear path to liquidity. Therefore, competition is usually a positive development which can help, not hurt, a firm's chances of getting funding.

Founders as Managers

Founders play a special role in young firms as leaders and visionaries. Yet managing a firm requires different skills than starting one. Because they are so vital to a young company, most VCs believe that firms are best led by their founders rather than outsiders. Replacing a founder is very disruptive to a firm, so VCs take such actions strictly as a last resort. Thus, VCs support founders wherever possible to help them become good managers, either through coaching or augmenting the team with experienced line managers.

VCs Focus on Projections

Venture capital firms expect companies not only to present realistic forecasts showing solid growth but also to meet them consistently. For early stage firms, VCs focus intensely on liquidity and growth indicators such as near term (12-18 month) budgets, cash reserves, and cash burn rates. Later stage VCs expect firms to show sufficient market penetration, growth rates, profitability, and operating margins to effect a liquidity event. Venture capital firms will evaluate managers based on achieving projections.

WHY WORK WITH AN INVESTMENT BANK TO RAISE VENTURE CAPITAL?

Raising venture capital without the advice of an investment banker places a company at significant risk of an elongated, inefficient, and potentially unsuccessful fundraising process. An investment banker will know exactly what information a venture capital firm will expect to receive and will package it to the maximum benefit of the company. Further, an investment banker can bring many more potential investors to the table; this yields a greater chance of completing the round and getting the highest possible valuation. Using an investment banker will also significantly cut down management's time and effort required to raise capital and speed its time to funding by running a consistent and efficient process. An investment banker can also protect a firm from agreeing to onerous terms that can limit its strategic and financial flexibility.

HOW DO I KNOW IF AN INVESTMENT BANK IS QUALIFIED TO RAISE VENTURE CAPITAL FOR MY FIRM?

There are several areas on which to focus when evaluating investment banks, including:

- Deep understanding of the venture capital market and fundraising process
- Knowledge of the client's market and competitive positioning
- Strong relationships with hundreds of relevant venture capital firms
- History of successful fundraising for companies of similar size and industry
- High level of senior banker involvement
- Banker responsiveness to client needs
- Development of creative alternatives

An initial meeting with a senior banker should enable a firm to determine if a particular investment bank has the necessary qualifications and track record to meet its needs. If so, a follow-up meeting where the banker makes a formal presentation regarding the firm's potential investors and a tentative marketing plan should be arranged. These two meetings should provide the basis for deciding on the appropriate investment bank for a firm and its fundraising needs.

WILL VENTURE CAPITAL FIRMS INVEST IN DEALS BROKERED BY INVESTMENT BANKS?

All venture capital firms focused on growth or later stage investments will invest in transactions marketed by investment banks. Generally these venture capital firms like the quality and geographic diversity of the transactions that investment banks offer, even if the process is competitive. A very small number of venture capital firms, usually seed and early stage funds, will not invest in brokered deals because they do not want to participate in a competitive process where valuations may get bid up.

HOW MUCH DOES IT COST TO RAISE VENTURE CAPITAL VIA AN INVESTMENT BANK?

Raising venture capital through an investment bank is very cost effective. The vast majority of the fees associated with raising venture capital (roughly 90%-95%) are payable only upon successful consummation of a venture capital investment. These fees usually range from 5%-7% of the funds raised and are paid directly out of the proceeds, so the company does not face substantial out-of-pocket costs. The balance of the fees is paid as part of a nominal up-front or monthly retainer.

Dual Process Strategies

A company's shareholders often can be torn between growing the firm and selling out. One solution to this dilemma is to conduct a dual process of simultaneously marketing a venture capital round alongside a sale to strategic buyers. If the company can attain a valuation that is compelling from a strategic partner, the firm is sold. If not, it continues on its path with a venture capital round. Since the two processes are similar, a firm benefits from significant efficiencies and creates additional negotiating leverage.

Numbers Game of Fundraising

Firms need to contact dozens of VCs in order to raise an investment round. Assuming that venture capital firms appropriate for the company's stage of development and industry are contacted, roughly 20%-40% of those VCs will be interested in having an initial meeting. 20%-50% of initial meetings will result in additional follow-up due diligence meetings. Of those VCs conducting due diligence, less than half will offer term sheets. To receive one term sheet, a firm should speak with up to 50 VCs. If a firm wishes to get the best possible terms, at least 50-100 VCs need to be contacted.

Madison Park Group is an investment banking firm focused on providing financial advisory services to technology and business services companies.

Madison Park Group

Innovation & Growth

Madison Park Group is comprised of an experienced team of investment bankers. Our banking team has closed over 150 corporate finance transactions with a total transaction value in excess of $30 billion. The Madison Park Group team has been involved in M&A, strategic advisory, private placement, IPO, secondary public offering and debt financing transactions for companies in a range of industries including:

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eCommerce
Transaction processing
Business Process Outsourcing
IT Services
Online Services
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