

“Wisdom consists of the anticipation of consequences.”

Norman Cousins (1915-1990)

VENTURING INTO REALITY

In this Newsletter we deal with one of the most confusing issues to management teams: the linkage between strategy, funding requirements, and implied financial performance. This discussion is often very enlightening to our customers. Invariably, becoming more familiar with how the economics of the venture capital funding works leads to improvement in communication and understanding between management teams, boards and investors.

A VC DOLLAR

We start with the perspective of venture capitalists (VCs). In essence, they promise returns that are more attractive than the public equity and debt markets to folks called limited partners. To achieve these returns, VCs buy portions of small, private companies. As part of this investment the VCs often take a board seat and aid the management team with staffing and operational assistance.

So, let's do the numbers. A reasonable return that a limited partner expects when investing money with a VC is approximately 20% per annum. A VC typically charges a limited partner about 2% of the invested amount of the money each year, which means the invested money needs to return about 22% per year. When the fund closes, the VC firm gets to keep approximately 20% of the profit. When you put this all together, the VC needs to generate a return of almost 25% annually on invested capital.

Before we run the math, it is important to understand that the VC has to pay cash back to the limited partner. To get this cash, the VC must eventually sell their stake in the portfolio companies. When they sell their stake in the companies, primarily by either taking the company public or selling the company, this is called exiting, or more simply “the exit”. One criterion for success with a VC-backed company is that they eventually find an exit for the company.

Let's look at what is involved with generating a return that makes a VC look good. At first thought this return doesn't seem so difficult for the VC to achieve with start-ups. Start-ups can grow very fast, but the reality is many of them fail. Solid statistics on the failure rates of venture-backed companies aren't easy to obtain, so let's look at two scenarios.

In the first, only one of six start-ups finds an exit. The second scenario is that one of three start-ups finds an exit. Next, we vary the length of time to get to an exit from 3 to 10 years. Then we calculate the average rate of return on invested capital the VC needs to achieve from a company that survives to a successful exit to offset the losses from the unsuccessful companies.

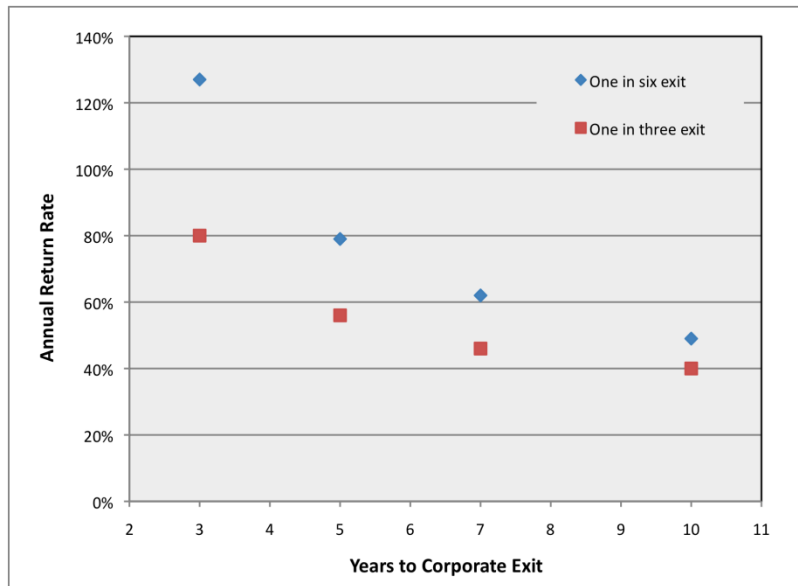


Figure 1. The annual rate of return of invested capital required from a successful start-up company. In blue, only one of six companies completes a successful exit, increasing the return requirement.

The reality of risk is made very clear in this graph. If a VC can improve their survival rate, the return requirements for the businesses drop substantially. When a VC hammers away to understand the underlying risk factors of a company, including things like analyzing competitive advantage, market positioning, staff qualifications and track record of execution, they are doing this to understand and minimize the risk of the company in which they are investing.

In addition to simply minimizing risk, a good VC will work to ensure that if a high-risk company is funded, the potential upside of the company is large. In the situation where a company has a more limited return potential, a strong VC will verify that the overall risk profile of the company is correspondingly modest.

Key Point: *VC firms appropriately focus on risk. They seek to minimize risk and to weigh potential returns against the risks that the company faces.*

The second key critical point is that the start-up company executes rapidly. As time goes on, the return requirements begin to quickly ramp up. Figure 2 shows the required return for each and every invested dollar. In the situation where only one in six makes it to an exit, a company that exits in three years must return \$11 for each \$1 invested, with that number increasing to \$58 for each \$1 invested if the company exits in ten years. Risk reduction dramatically reduces these numbers, as well as, providing the company with substantially more time to achieve an acceptable valuation. As an example, if the survivability rate is improved to one exit in three companies, achieving a 10x return on an invested dollar can take nearly seven years, up by more than a factor of two in the one in six exit scenario.

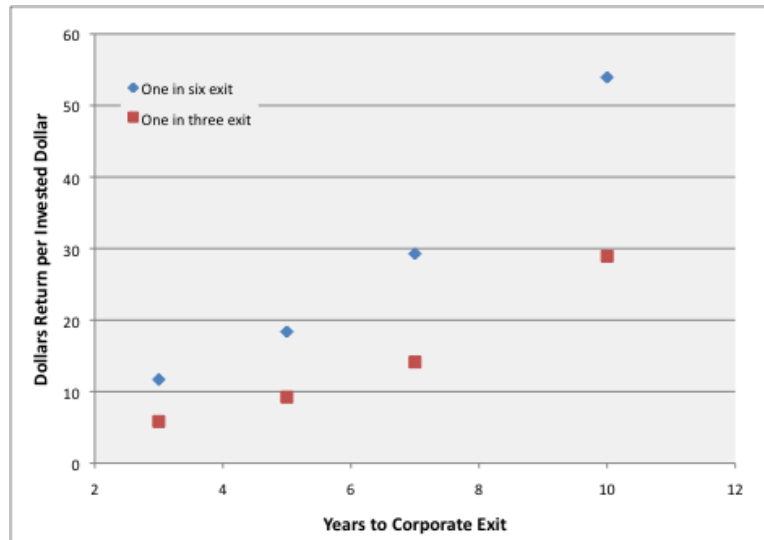


Figure 2 The dollars returned for each invested dollar, in a high-risk and low-risk scenario.

Key Point: *If only one of six companies makes it to a successful exit five years after funding, that company needs to return \$18 for every dollar initially invested.*

Key Point: *When a VC improves the survivability of portfolio companies this allows for more time to build company value.*

A SIMPLE EXAMPLE

Let's assume that a VC puts \$10M into a company to purchase 25% of the company. The company uses the money to build a valuable business that sells for \$280M five years after funding.

Since \$10M represents 25% of the company, the valuation of the company is \$40M.

The VC receives 25% of \$280M, or \$70M.

The annual internal rate of return on this single investment is 47%.

However, we've left many parts out.

The management fee of 2% per year for five years is approximately \$1M.

Assuming that the VC firm is granted 20% of the profit, the money of the limited partners is reduced by approximately $(\$70M - \$11M) \times 0.2 \sim \$12M$, to \$58M.

The annual return on this company, as seen by the limited partner, is 39%.

Let's assume that the VC has made five identical investments, totally \$60M, and only this company finds a successful exit.

The total money returned to the limited partners for this portfolio, including adjusting the management fee and reducing the profit taken by the VC firm, is \$70M, less a management fee of 2% of \$60M for five years (\$6M), less 20% of the profit of \$4M, or ~\$63M.

The overall annual return for this portfolio, with one successful exit, is 1%.

While this example is very simplistic, it illustrates several key points that govern the behavior of a venture investor. The central questions of the venture capital investor revolve around how much risk exists, what the returns will be if successful, and how long the businesses will take to develop.

DILUTION

The assumed bias in companies about dilution is that it is awful, and VCs will dilute management teams unfairly. In reality, the business situation is a bit more interesting. Let's start by going through the simple mechanics of what happens when a VC puts money into a company (no, we're not going to go through all the variations of what happens in a capitalization table. This is a newsletter, not a sleep aid).

Entrepreneurs often wish to minimize dilution. They fear giving away their upside and/or control of the direction of the company. However, the other way to look at this situation is that with insufficient cash, the company will have difficulty growing at the rapid pace required by the VC model.

Key Point: *The criterion for seeking funding is simple: It is appropriate to seek funding when the value of the business to the entrepreneurs is increased with the cash infusion and subsequent growth.*

Key Point: *The test for granting funding is also simple: It is appropriate to fund a business if the business plan is clean, with risks articulated and managed, and the enterprise has a direct path to creating a business with returns in-line with the VC model.*

It is only when both of these conditions are met that funding should occur.

DILUTION STRATEGIES

Minimal cash

This strategy is not all that complicated. Here the company banks on things going right and takes the least amount of cash needed (provided everything goes right). The real difficulty is that something always goes wrong in start-ups (and life). Almost every start-up ends up needing more cash than initially forecast. This results in more cash being burned faster than management predicted. Consequently, the company ends up going back to investors to request more cash, with a much more dismal business outlook than initially promised to the investors. At this point, the management team is losing credibility, the investors now have

more leverage, and the subsequent funding is usually at much less favorable terms than the original funding.

Aggressively Maximizing Pre-money Valuation

In the superficial version of this strategy, management creates an extremely aggressive strategic plan, with very high and fast revenue growth, and hard to achieve profitability and product roll-up schedules. If the VCs “buy into” these assumptions, the pre-money valuation will, indeed, be higher, resulting in less dilution and the management team can generally get more cash needed for the construction of the company.

The downside occurs when the management team cannot execute on the aggressive schedule for product delivery, and the financial performance of the company misses the forecast. Trust in the management team begins to erode, hurting the chances of the company moving forward to a good exit.

Lever the company

Debt may often be obtained without giving away equity, or involving a VC. However, in this economy debt has become harder to obtain, with more stringent terms and covenants than in the past. Typically, failing to meet any of these terms or covenants results in the lending institution being able to take an ownership stake in the company. Unfortunately, the financial performance of a young company is difficult to forecast. Because of the inherent risk with debt, we generally guide start-ups away from accepting debt.

THE IDEAL CASE

In this strategy the entrepreneur assembles or understands what is needed to develop a strong management talent and has a thorough understanding of the market, product placement, and product technology. The management team has also developed a plan that leverages the company’s core competencies and sets realistic goals for product development, market acceptance, cash usage, and financial performance. This type of preparation is much easier for a VC to fund, as the risks are better understood and the management team is asking for enough cash to execute through the problems that will invariably occur. This is as it requires thoughtful strategic planning work, good implementation planning and a realistic assessment of risk factors, including the existing management team, the state of product development and market conditions.

This type of plan is often difficult for a management team to develop when they are in the midst of running hard to develop a product and a company. InSite can help teams think through and develop their core competency skill sets, understand their markets, and develop strategic plans. In addition, we can help the management work to understand the risks attendant with the plan and help them put actions in place to minimize or eliminate risk factors. We also help teams better understand the perspective of the VC, arrange for meetings with members of the venture community willing to provide constructive feedback, and help them find the funding needed to launch companies and dreams.



SUMMARY

- Be rational with your financial projections.
- Be thorough. Document your assumptions, have good conversations with customers guiding your product ideas, and use this information to arrive at solid financial statements.
- Ask for enough money to run hard at your business objectives, and accept some dilution to get the cash firepower to work through the inevitable problems that will occur.
- Unless you have no market risk and no technical risk, don't use debt.

Cheers,

The InSite Staff

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