Venture Capital,

Common Practices

BME CAPITAL MANAGEMENT

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An entrepreneur seeking to raise venture capital, will do well to familiarize himself/ herself with common venture capital practices, so as to minimize frustrations and difficulties during the fundraising process.

This article aims to describe some such practices, for the benefit of the entrepreneur.

Venture capital firms do not sign non disclosure agreements or other sorts of confidentiality agreements. This is a particular source of frustration and anxiety with entrepreneurs. Typically, the project that an entrepreneur presents to a venture capital firm is his/her precious "baby" to which he/ she is emotionally attached after having put into it the best of his/ her energy and talent. Any exposure of the project to another person, without the protection (even if partial) of a confidentiality agreement, is an understandable source of much concern.

But then, in most cases, venture capital firms refuse to sign such agreements. Why is that?

To begin with, the signing of an NDA, naturally exposes the venture capital fund to potential legal claims on the ground of real or perceived violation, e.g. by way of competing with the project under discussion by investing in (or even talking to) a competing project in the future. Now, the typical venture capital firm reviews hundreds of projects per year, and lives within a vibrant and diverse technology startup community. Therefore there is a high probability that the said venture capital firm will encounter at least one more project that seemingly competes with that for which the firm refused to sign an NDA. Also, as a matter of habit, the venture capital firm expects its future relationship with the entrepreneur to be based on mutual trust, and an NDA ,be it in reality or in perception, lays a foundation of distrust to the relationship, which is unhealthy.

Yet another facet of venture capital investment that typically surprises and frustrates entrepreneurs, is that the length of time it takes to close an investment transaction. Typically spreads over at least three months (and more often six to nine months between the day the entrepreneur meets the firm and the day the fund’s money comes in). One reason is that venture capital investments are, by definition, very risky. For this reason, the due-diligence performed by the firm tends to be long and convoluted. Another reason, is that venture capital investors like to syndicate any investment they make with other investors, preferably other venture capital funds.

This poses to the entrepreneur a challenge of selling not just to one firm, but to several. Hence, each member of the investment syndicate needs to complete his/her own due-diligence and negotiate deal terms, hence more time is required.

Venture capital firms are typically managed by more than one partner. Normally, the firm's investment decisions are made by consensus among the partners, or at least the senior ones. This forces the entrepreneur to make a group sale. Be it serially or by ensemble. This unavoidably, extends the time to investment decision. An Entrepreneur, trying to raise capital from a given venture capital firm will do well to explore and understand the internal decision-making procedures of the firm and adjust his/her salesmanship to them. Such firms tend to make substantial efforts to check out the entrepreneurs they are going to invest in. The entrepreneurs themselves will do well to check out the firm as well. This may be done by talking to other entrepreneurs the same venture capital fund has invested in and by spending time with the firm before the investment is closed. This in order to verify personal compatibility and suitability of the particular firm to the current and future needs of the entrepreneur's project.

There is more to be said on venture capital practices that can benefit the entrepreneur: For instance, by coining the term "OPM business", where OPM stands for Other People's Money. Being in the OPM business means running an investment vehicle, such as a venture capital fund whose capital originates from sources other than the managers of the fund themselves, in other words it means investing other people's money. Most venture funds are OPM businesses, i.e. they are made of capital raised from a collection of investors, some of whom may be private, while other are institutional. This means that the managers of a venture fund are often responsible to their own investors, this means they have to be able to explain and communicate their investment decisions to their own investors and frequently report on how those investments are doing. This responsibility may turn heavy and burdensome on the shoulders of the venture fund managers. An entrepreneur, who is financed by professional venture capital, will do well to assist the managers of the venture funds that have invested in him/her, to assist them in living up to their OPM responsibilities. This means, for instance, to frequently provide them written and oral reports that can help them report to their own investors and to help them understand his/her business which very often, particularly in technology and science-based start-ups is no trivial matter. If a venture fund manager understands the science and technology that stand at the basis of one of the fund's portfolio companies, then he/ she can explain it to fund investors. If they don't, they cannot. Differently put, an entrepreneur backed by venture funds will gain points if he/she helps the fund managers meet their OPM responsibilities.

Indeed, most venture capital firms are in the OPM business and the entrepreneur should help them explain to and communicate with their investors.

Yet another common practice among venture capitalists, which is often not well understood by entrepreneurs, is the following one: when experienced, venture fund managers are approached by an entrepreneur asking for a certain sum of money. The fund manager (At least the more experienced among them), will assume that, in order to get off the ground, the startup under discussion will need at least three times the capital asked by the entrepreneur. Differently put, it means that the experienced investor assumes a priori that for every dollar he/she invests in the said startup up-front he/she will sooner or later be asked to invest at least two more. The entrepreneur heading the startup will do well to adopt this assumption and incorporate it into his/her work plan. In other words, the advice to the entrepreneur would be "Prepare for this financing axiom, and if you cannot beat it, join it", that is to say, adopt it yourself.

Another venture capital financing axiom that entrepreneurs often resist, but are hereby advised to "join rather than fight" has to do with investment options. Let us say an entrepreneur's business plan indicates that his/her startup will need two million dollars in order to take off. A venture capital fund manager, may very well respond to such request as follows: "all right, I'll give you one million dollars now, but give me a two years option to invest one million dollars more at double today's valuation (or stock price)". Very typically, an entrepreneur would resent such financing formula, on the ground that the business is expected to need the full two million dollars. But what happens if the venture investor decides not to exercise the two years option? The startup will then be "stuck" with no capital to further develop. The entrepreneur often feels that a one-sided "put option" is unfair and should therefore be accompanied by a reciprocal "call option", that is to say that the startup should also have an option to call for the second million dollars if and when it needs it. Otherwise, so feels the entrepreneur, the option mechanism does not provide for the company's expected needs in full. "What if the option is not exercised"? So asks the entrepreneur and becomes increasingly anxious, sometimes to the extent of turning down the entire deal without having an alternative one. The answer is that options tend to be exercised. Simply because they may be looked at as roads that have already been paved. It is much easier for the venture fund manager to exercise the option as defined and by terms already negotiated, than to begin another round of negotiation, of due-diligence and of selling the said investment to his/her fund management partners and to the fund investors, it is easier to follow a road that has already been paved than pave a new one. In short, "pre-defined" investment options tend to be exercised.