

**EXHIBIT 2** Want Beverages Inc.'s Price and Cost Information

	Per 24 Bottle Case	Per Bottle
<b>Suggested Retail Price (including tax)</b>		\$2.50
<b>Selling Price to Retailer</b>	<b>\$30.00</b>	\$1.25
<b>Production Costs:</b>		
Bottling Fee	\$7.25	\$0.30
Bottles	\$3.84	\$0.16
Labels	\$1.77	\$0.07
Ingredients	\$1.21	\$0.05
Donations	\$3.60	\$0.15
<b>Total Production Costs</b>	<b>\$17.67</b>	<b>\$0.73</b>
<b>Gross Margin</b>	<b>\$12.33</b>	<b>\$0.52</b>

Source: Want company records. Figures may have been disguised for confidentiality.



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## C.H.A.P.T.E.R

## 9

## FINANCING THE VENTURE

*Happiness to an entrepreneur is a positive cash flow.*

Fred Adler  
Venture Capitalist

**RESULTS EXPECTED** Upon completion of this chapter, you will be able to:

1. Describe critical issues in financing new ventures.
2. Discuss the difference between entrepreneurial finance and conventional managerial or corporate finance.
3. Appreciate the process of crafting financial and fund-raising strategies and the critical variables involved, including identifying the financial life cycles of new ventures, a financial strategy framework, and investor preferences.
4. Understand the capital markets food chain and its implications.
5. Identify informal and formal investment sources of equity capital.
6. Learn how to be vigilant in finding, contacting, and dealing with equity investors.
7. See how venture capital investors make decisions.

**RESULTS EXPECTED**

### VENTURE FINANCING: THE ENTREPRENEUR'S ACHILLES' HEEL

There are three core principles of entrepreneurial finance: (1) more cash is preferred to less cash, (2) cash sooner is preferred to cash later, and (3) less-risky cash is preferred to more-risky cash. While these principles seem simple enough, entrepreneurs, chief executive officers, and division managers often seem to ignore them. To these individuals, financial analysis seems intimidating, regardless of the size of the company. Even management teams, comfortable with the financial issues, may not be adept at linking strategic and financial decisions to their companies' challenges and choices.

#### Financial Management Myopia: It Can't Happen to Me

Financial management myopia is a combination of self-delusion and just plain not understanding the complex dynamics and interplay between financial management and business strategy. Why is this so?

**Getting Beyond “Collect Early, Pay Late”** During our 40-plus years as educators, authors, directors, founders, and investors in entrepreneurial companies, we have met a few thousand entrepreneurs and managers, company founders, presidents, and the chief executive officers of middle-market companies. By their own admission, they felt uniformly uncomfortable, if not downright intimidated and terrified, by their lack of expertise in financial analysis and its relationship to management and strategy. The vast majority of entrepreneurs and non-financial managers are disadvantaged. Beyond “collect early, pay late,” there is precious little sophistication and an enormous level of discomfort when it comes to these complex and dynamic financial interrelationships. Even good managers who are revelling in major sales increases and profit increases often fail to realize until it's too late the impact increased sales have on the cash flow required to finance the increased receivables and inventory.

**The Spreadsheet Mirage** It is hard to imagine any entrepreneur who would not want ready answers to many financial vigilance questions, such as in Exhibit 9.1. Until now, however, getting the answers to these questions was a rarity. If the capacity and information are there to do the necessary analysis (and all too often they are not), it can take up to several weeks to get a response. In this era of spreadsheet mania, more often than not, the answers will come in the form of a lengthy report with innumerable scenarios, pages of numbers, backup exhibits, and possibly a presentation by a staff financial analyst, controller, or chief financial officer.

Too often the barrage of spreadsheet exhibits is really a mirage. What is missing? **Traditional spreadsheets can only report and manipulate the data.** The numbers may be there, the trends may be identified, **but the connections and interdependencies between financial structure and business decisions inherent in key financial questions may be missed.** As a result, gaining true insights and getting to creative alternatives and new solutions may be painfully slow, if not interminable. By themselves, spreadsheets cannot model the more complex financial and strategic interrelationships that entrepreneurs need to grasp. And for the board of directors, failure to get this information would be fatal and any delay would mean too little and too late. Such a weakness in financial know-how becomes life threatening for entrepreneurs such as those noted earlier, when it comes to anticipating the financial and risk-reward consequences of their business decisions. During a financial crisis, such a weakness can make an already dismal situation worse.

**EXHIBIT 9.1 The Crux of It: Anticipation and Financial Vigilance**

To avoid some of the great tar pits like the ones described earlier, entrepreneurs need answers to questions that link strategic business decisions to financial plans and choices. The crux of it is anticipation: *What is most likely to happen? When? What can go right along the way? What can go wrong? What has to happen to achieve our business objectives and to increase or to preserve our options?* Financially savvy entrepreneurs know that such questions trigger a process that can lead to creative solutions to their financial challenges and problems. At a practical level, financially astute entrepreneurs and managers maintain vigilance over numerous key strategic and financial questions:

- What are the financial consequences and implications of crucial business decisions such as pricing, volume, and policy changes affecting the balance sheet, income statement, and cash flow? How will these change over time?
- How can we measure and monitor changes in our financial strategy and structure from a management, not just a GAAP, perspective?
- What does it mean to grow too fast in our industry? How fast can we grow without requiring outside debt or equity? How much capital is required if we increase or decrease our growth by X percent?
- What will happen to our cash flow, profitability, return on assets, and shareholder equity if we grow faster or slower by X percent?
- How much capital will this require? How much can be financed internally and how much will have to come from external sources? What is a reasonable mix of debt and equity?
- What if we are 20% less profitable than our plan calls for? Or 20% more profitable?
- What should be our focus and priorities? What are the cash flow and net income breakeven points for each of our product lines? For our company? For our business unit?
- What about our pricing, our volume, and our costs? How sensitive are our cash flow and net income to increases or decreases in price, variable costs, or volume? What price/volume mix will enable us to achieve the same cash flow and net income?
- How will these changes in pricing, costs, and volume affect our key financial ratios and how will we stack up against others in our industry? How will our lenders view this?
- At each stage—start-up, rapidly growing, stagnating, or mature company—how should we be thinking about these questions and issues?

Time and again, the financially fluent and skillful entrepreneurs push what would otherwise be an average company toward and even beyond the brink of greatness. Clearly, financially knowledgeable CEOs enjoy a secret competitive weapon that can yield a decisive edge over less financially skilled entrepreneurs.

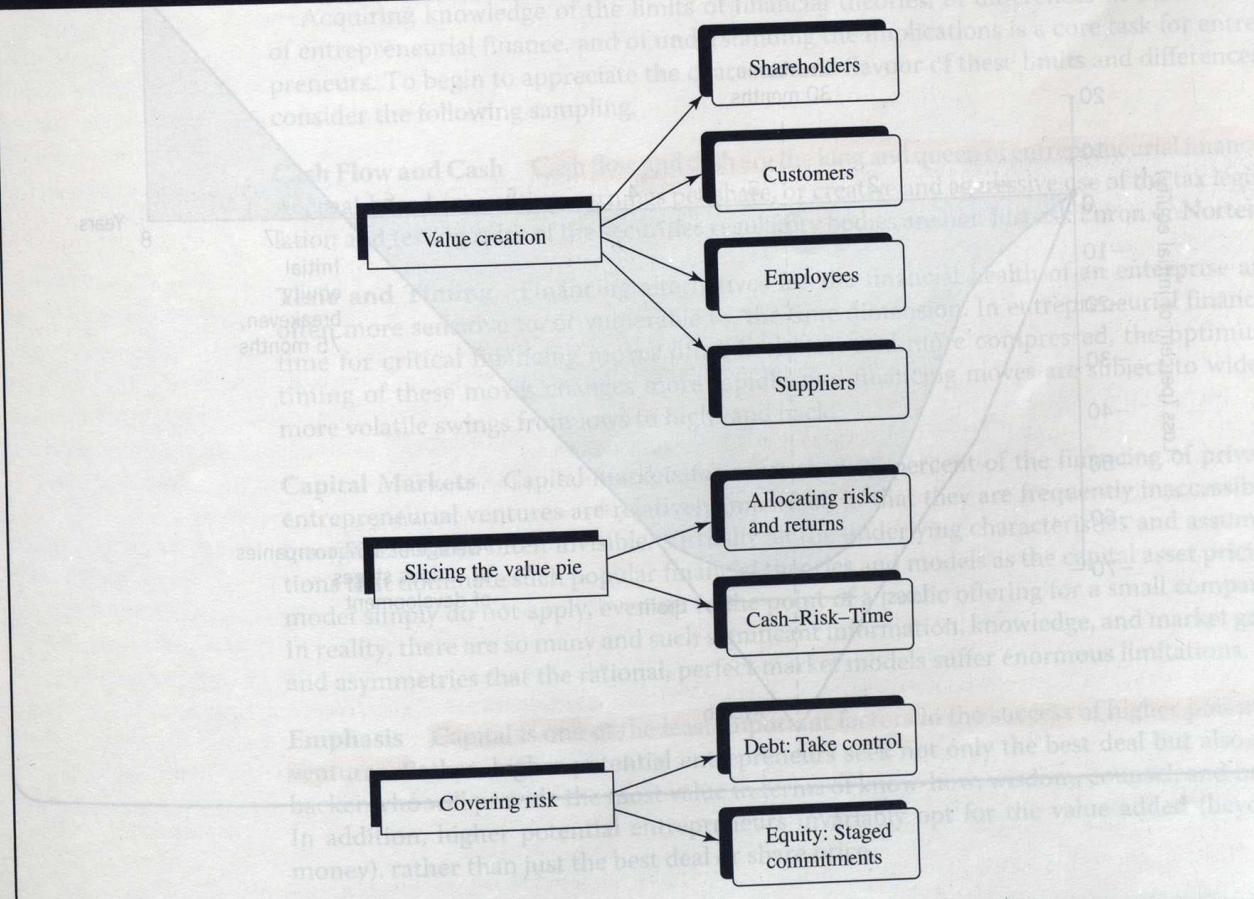
**Critical Financing Issues**

Exhibit 9.2 illustrates the central issues in entrepreneurial finance. These include the creation of value, the slicing and dividing of the value pie among those who have a stake or have participated in the venture, and the handling of the risks inherent in the venture. Developing financing and fund-raising strategies, knowing what alternatives are available, and obtaining funding are tasks vital to the survival and success of most higher potential ventures.

As a result, entrepreneurs face certain critical issues and problems, which influence the financing of entrepreneurial ventures, such as:

- **Creating value.** Who are the constituencies for whom value must be created or added to achieve a positive cash flow and to develop harvest options?
- **Slicing the value pie.** How are deals, both for start-ups and for the purchases of existing ventures, structured and valued, and what are the critical tax consequences of different venture structures? What is the legal process and what are the key issues involved in raising outside risk capital?
- **Selling the idea.** How do entrepreneurs make effective presentations of their business plans to financing and other sources? What are some of the nastier pitfalls, minefields, and hazards that need to be anticipated, prepared for, and responded to? How critical and sensitive is timing in each of these areas?

**EXHIBIT 9.2 Central Issues in Entrepreneurial Finance**

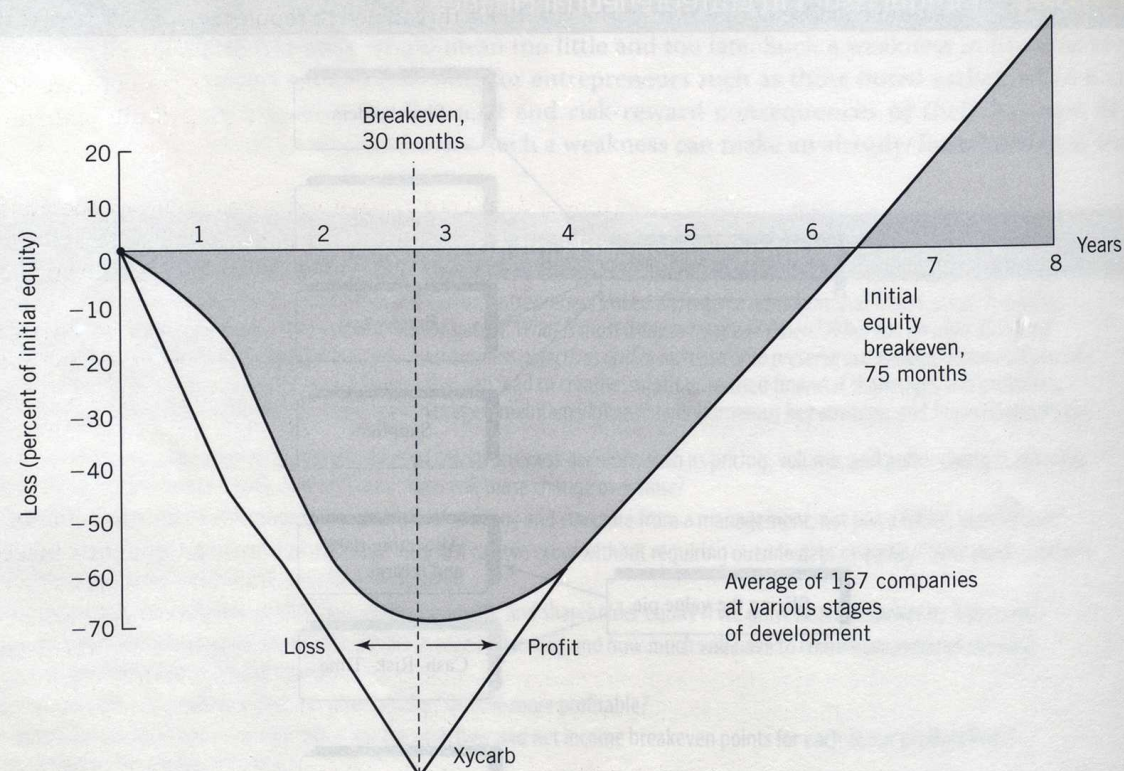


- **Covering risk.** How much money is needed to start, acquire, or expand the business, and when, where, and how can it be obtained on acceptable terms? What sources of risk and venture capital financing—equity, debt, and other innovative types—are available, and how is appropriate financing negotiated and obtained?
- Who are the financial contacts and networks that need to be accessed and developed?
- How do successful entrepreneurs marshal the necessary financial resources and other financial equivalents to seize and execute opportunities, and what pitfalls do they manage to avoid, and how?
- Can a staged approach to resource acquisition mitigate risk and increase return?

A clear understanding of the financing requirements is especially vital for new and emerging companies because new ventures go through financial 'hell' compared to existing firms, both smaller and larger, that have a customer base and revenue stream. In the early going, new firms are gluttons for capital, yet are usually not very debt-worthy. To make matters worse, the faster they grow, the more gluttonous is their appetite for cash.

This phenomenon is best illustrated in Exhibit 9.3 where loss as a percentage of initial equity is plotted against time.<sup>1</sup> The shaded area represents the cumulative cash flow of 157 companies from their inception. For these firms, it took 30 months to achieve operating breakeven and 75 months (or going into the seventh year) to recover the initial equity. As can be seen from the illustration, *cash goes out for a long time before it starts to come in*. This phenomenon is at the heart of the financing challenges facing new and emerging companies.

**EXHIBIT 9.3** Initial Losses by Small New Ventures



## Entrepreneurial Finance: The Owner's Perspective

If an entrepreneur who has had responsibility for financing in a large established company and in a private emerging firm is asked whether there are differences between the two, the person asking will get an earful. While there is some common ground, there are both stark and subtle differences, both in theory and in practice, between entrepreneurial finance as practised in higher potential ventures and corporate or administrative finance, which usually occurs in larger, publicly traded companies. Further, there are important limits to some financial theories as applied to new ventures.

Students and practitioners of entrepreneurial finance have always been dubious about the reliability and relevance of much of so-called modern finance theory, including the capital asset pricing model (CAPM), beta, and so on.<sup>2</sup> Apparently, this skepticism is gaining support from a most surprising source, corporate finance theorists. As reported in a *Harvard Business Review* article:

One of the strongest attacks is coming from a man who helped launch modern finance, University of Chicago Professor Eugene Fama. His research has cast doubt on the validity of a widely used measure of stock volatility: beta. One group, however, eschews the scientific approach altogether, arguing that investors aren't always rational and that managers' constant focus on the markets is ruining corporate America. In their view, the highly fragmented U.S. financial markets do a poor job of allocating capital and keeping tabs on management.<sup>3</sup>

Challenging further the basic assumptions of corporate finance, the author continued: "These three concepts, the efficient market hypothesis, portfolio theory, and CAPM, have had a profound impact on how the financial markets relate to the companies they seek to value. . . . They have derailed and blessed countless investment projects."<sup>4</sup> Nancy Nichols, concluded that "despite tidy theories, there may be no single answer in a global economy."<sup>5</sup>

It is especially noteworthy that even the most prestigious of modern finance theorists, prominent Nobel laureate Robert Merton of Harvard University, may have a lot to learn. His works and theories of finance were the basis for Long Term Capital Management, Inc. The total collapse of that firm in the late 1990s threatened to topple the entire financial system.

Acquiring knowledge of the limits of financial theories, of differences in the domain of entrepreneurial finance, and of understanding the implications is a core task for entrepreneurs. To begin to appreciate the character and flavour of these limits and differences, consider the following sampling.

**Cash Flow and Cash** *Cash flow and cash are the king and queen of entrepreneurial finance.* Accrual-based accounting, earnings per share, or creative and aggressive use of the tax legislation and testing rules of the securities regulatory bodies are not. Just ask Enron or Nortel!

**Time and Timing** Financing alternatives for the financial health of an enterprise are often more sensitive to, or vulnerable to, the time dimension. In entrepreneurial finance, time for critical financing moves often is shorter and more compressed, the optimum timing of these moves changes more rapidly, and financing moves are subject to wider, more volatile swings from lows to highs and back.

**Capital Markets** Capital markets for more than 95 percent of the financing of private entrepreneurial ventures are relatively imperfect, in that they are frequently inaccessible, unorganized, and often invisible. Virtually all the underlying characteristics and assumptions that dominate such popular financial theories and models as the capital asset pricing model simply do not apply, even up to the point of a public offering for a small company. In reality, there are so many and such significant information, knowledge, and market gaps and asymmetries that the rational, perfect market models suffer enormous limitations.

**Emphasis** *Capital is one of the least important factors in the success of higher potential ventures.* Rather, higher potential entrepreneurs seek not only the best deal but also the backer who will provide the most value in terms of know-how, wisdom, counsel, and help. In addition, higher potential entrepreneurs invariably opt for the value added (beyond money), rather than just the best deal or share price.

**Strategies for Raising Capital** Strategies that optimize or maximize the amount of money raised can actually increase risk in new and emerging companies, rather than lower it. Thus, the concept of “staged capital commitments,” whereby money is committed for a 3- to 18-month phase and is followed by subsequent commitments based on results and promise, is a prevalent practice among venture capitalists and other investors in higher potential ventures. Similarly, wise entrepreneurs may refuse excess capital when the valuation is less attractive and when they believe that valuation will rise substantially.

**Downside Consequences** Consequences of financial strategies and decisions are eminently more personal and emotional for the owners of new and emerging ventures than for the managements of large companies. The downside consequences for such entrepreneurs of running out of cash or failing are monumental and relatively catastrophic, since personal guarantees of bank or other loans are common. Contrast these situations with that of the 100 highest paid executives in Canada. The average one of these 100 CEOs has earned as much by January 2 at 9:46 a.m. (assuming he or she works 9 to 5) as the average Canadian earns in a full year. By the end of the workday on January 2, the average of the 100 top-paid CEOs in Canada will have earned \$70,000. The highest paid Canadian executive will have earned more than \$570,000 in those two days of work. “The average of the top 100 CEOs is paid as much in a year as 238 average Canadians. . . . The highest paid CEO makes as much as a small town—1,969 people—working at the average of wages and salaries, or 4,696 people working full-year at the minimum wage.”<sup>6</sup> With much of these compensation packages independent of performance, the downside for these executives is obviously quite low.

**Risk-Reward Relationships** While the high-risk/high-reward and low-risk/low-reward relationship (a so-called law of economics and finance) works fairly well in efficient, mature, and relatively perfect capital markets (e.g., those with money market accounts, deposits in credit unions, widely held and traded stocks and bonds, certificates of deposit), the opposite occurs too often in entrepreneurial finance to permit much comfort with this law. Some of the most profitable, highest return venture investments have been quite low-risk propositions from the outset. Many leveraged buyouts using extreme leverage are probably much more risky than many start-ups. Yet, the way the capital markets price these deals is just the reverse. The reasons are anchored in the second and third points noted above—timing and the asymmetries and imperfections of the capital markets for deals. Entrepreneurs or investors who create or recognize lower risk/very high-yield business propositions, before others jump on the Brink’s truck, will defy the laws of economics and finance.

**Valuation Methods** Established company valuation methods, such as those based on discounted cash flow models used in Wall Street and Bay Street mega deals, seem to favour the seller, rather than the buyer, of private emerging entrepreneurial companies. A seller loves to see an investment banker show up with a notebook computer and then proceed to develop “the 10-year discounted cash flow stream.” The assumptions normally made and the mind-set behind them are irrelevant or grossly misleading for valuation of smaller private firms because of dynamic and erratic historical and prospective growth curves.

**Conventional Financial Ratios** Current financial ratios are misleading when applied to most private entrepreneurial companies. For one thing, entrepreneurs often own more than one company at once and move cash and assets from one to another. For example, an entrepreneur may own real estate and equipment in one entity and lease it to another company. Use of different fiscal years compounds the difficulty of interpreting what the balance sheet really means and the possibilities for aggressive tax avoidance. Further, many of the most important value and equity builders in the business are off the balance sheet or are hidden assets: the excellent management team; the best scientist, technician, or designer; know-how and business relationships that cannot be bought or sold, let alone valued for the balance sheet.

**Goals** Creating value over the long term, rather than maximizing quarterly earnings, is a prevalent mind-set and strategy among highly successful entrepreneurs. Since profit is more than just the bottom line, financial strategies are geared to build value, often at the expense of short-term earnings. The growth required to build value often is heavily self-financed, thereby eroding possible accounting earnings.

## DETERMINING CAPITAL REQUIREMENTS

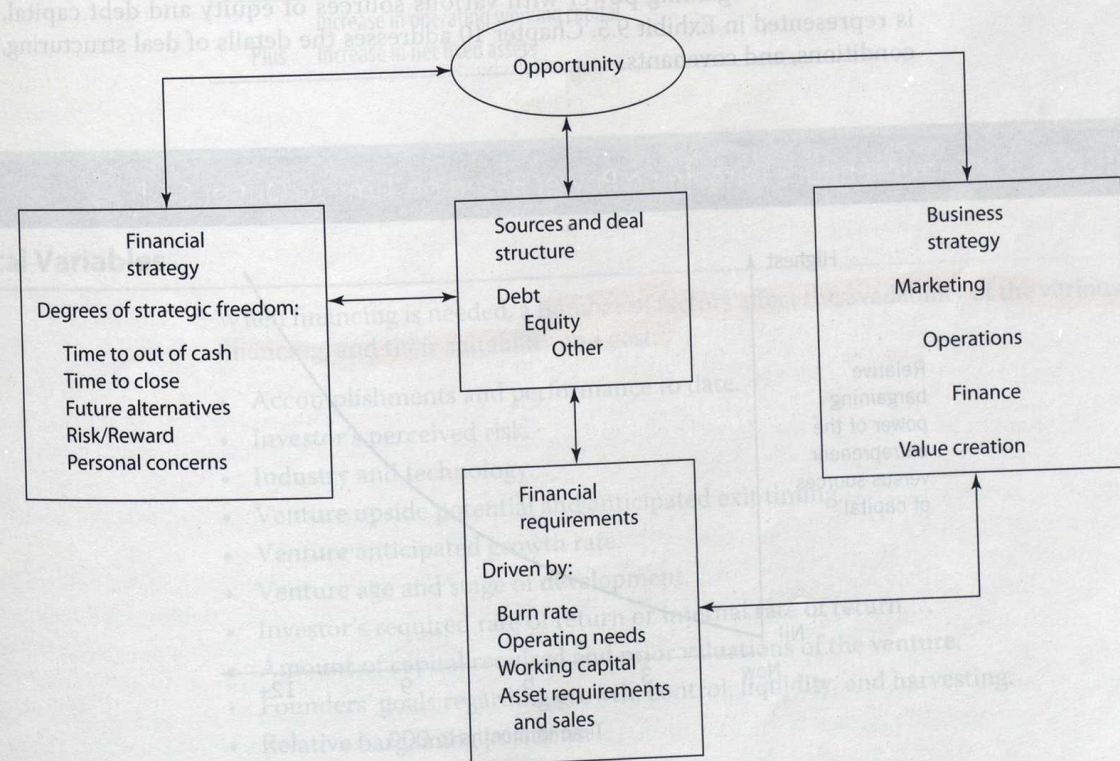
How much money does my venture need? When is it needed? How long will it last? Where and from whom can it be raised? How should this process be orchestrated and managed? These are vital questions to any entrepreneur at any stage in the development of a company. These questions are answered in the next two sections.

### Financial Strategy Framework

The financial strategy framework shown in Exhibit 9.4 is a way to begin crafting financial and fund-raising strategies. The exhibit provides a flow and logic with which an otherwise confusing task can be met. *The opportunity leads and drives the business strategy, which in turn drives the financial requirements, the sources and deal structures, and the financial strategy.* (Again, until this part of the exercise is well-defined, developing spreadsheets and “playing with the numbers” is just that—playing.)

Once an entrepreneur has defined the core of the market opportunity and the strategy for seizing it (of course, these may change, even dramatically), he or she can begin to examine the financial requirements in terms of (1) asset needs (for start-up or for expansion facilities, equipment, research and development, and other apparently onetime expenditures) and

EXHIBIT 9.4 Financial Strategy Framework



(2) operating needs (i.e., working capital for operations). This framework leaves ample room for crafting a financial strategy, for creatively identifying sources, for devising a fund-raising plan, and for structuring deals.

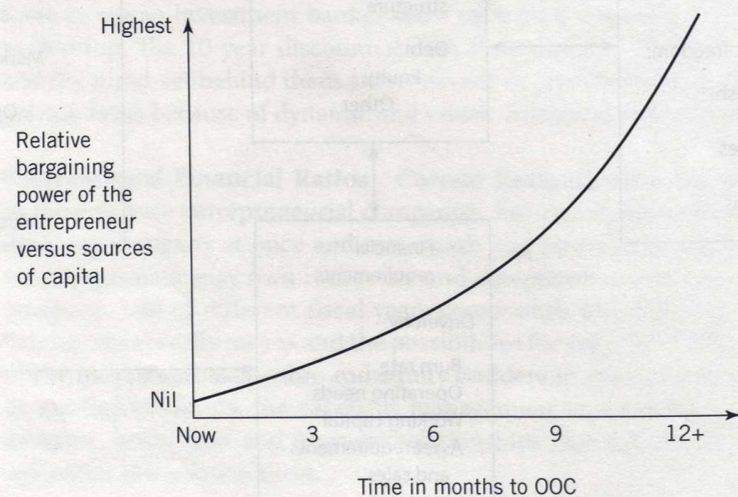
Each *fund-raising strategy*, along with its accompanying deal structure, commits the company to actions that incur actual and real-time costs and may enhance or inhibit future financing options. Similarly, each source has particular requirements and costs—both apparent and hidden—that carry implications for both financial strategy and financial requirements. The premise is that successful entrepreneurs are aware of potentially punishing situations, and that they are careful to “sweat the details” and proceed with a certain degree of wariness as they evaluate, select, negotiate, and craft business relationships with potential funding sources. In doing so, they are more likely to find the right sources, at the right time, and on the right terms and conditions. They are also more likely to avoid potential mismatches, costly sidetracking for the wrong sources, and the disastrous marriage to these sources that might follow.

Certain changes in the economic climate, such as the aftershocks felt following March 2000, October 1987, and Fall 2008, cause repercussions across financial markets and institutions serving smaller companies. These take the form of greater caution by both lenders and investors as they seek to increase their protection against risk. When the financial climate becomes harsher, an entrepreneur’s capacity to devise financing strategies and to effectively deal with financing sources can be stretched to the limit and beyond. Also, certain lures of cash that come in unsuspecting ways turn out to be a punch in the wallet. Later in this chapter we cover some of these potentially fatal lures and some of the issues and considerations needed to recognize and avoid these traps while devising a fund-raising strategy and evaluating and negotiating with different sources.

### Free Cash Flow: Burn Rate, OOC, and TTC

The core concept in determining the external financing requirements of the venture is free cash flow. Three vital corollaries are the burn rate (projected or actual), time to OOC (when will the company be Out Of Cash), and TTC (or the Time To Close the financing and have the cheque clear). These have a major impact on the entrepreneur’s choices and relative bargaining power with various sources of equity and debt capital, which is represented in Exhibit 9.5. Chapter 10 addresses the details of deal structuring, terms, conditions, and covenants.

**EXHIBIT 9.5** Entrepreneur’s Bargaining Power Based on Time to Out of Cash



The message is clear: If you are out of cash in 90 days or less, you are at a major disadvantage. OOC even in six months is perilously soon. But if you have a year or more, the options, terms, price, and covenants that you will be able to negotiate will improve dramatically. The implication is clear: Ideally, raise money when you do not need it.

The cash flow generated by a company or project is defined as follows:

	Earnings before interest and taxes (EBIT)
Less	Tax exposure (tax rate times EBIT)
Plus	Depreciation, amortization, and other non-cash charges
Less	Increase in operating working capital
Less	Capital expenditures

Economists call this result free cash flow. The definition takes into account the benefits of investing, the income generated, and the cost of investing, the amount of investment in working capital and plant and equipment required to generate a given level of sales and net income. The definition can fruitfully be refined further. Operating working capital is defined as:

	Transactions cash balances
Plus	Accounts receivable
Plus	Inventory
Plus	Other operating current assets (e.g., prepaid expenses)
Less	Accounts payable
Less	Taxes payable
Less	Other operating current liabilities (e.g., accrued expenses)

Finally, this expanded definition can be collapsed into a simpler one:<sup>7</sup>

	Earnings before interest but after taxes (EBIAT)
Less	Increase in net total operating capital (FA + WC)

where the increase in net total operating capital is defined as:

Plus	Increase in operating working capital
Plus	Increase in net fixed assets

## CRAFTING FINANCIAL AND FUND-RAISING STRATEGIES

### Critical Variables

When financing is needed, a number of factors affect the availability of the various types of financing, and their suitability and cost:

- Accomplishments and performance to date.
- Investor’s perceived risk.
- Industry and technology.
- Venture upside potential and anticipated exit timing.
- Venture anticipated growth rate.
- Venture age and stage of development.
- Investor’s required rate of return or internal rate of return.
- Amount of capital required and prior valuations of the venture.
- Founders’ goals regarding growth, control, liquidity, and harvesting.
- Relative bargaining positions.
- Investor’s required terms and covenants.

Numerous other factors, especially an investor's or lender's view of the quality of a business opportunity and the management team, will also play a part in a decision to invest in or lend to a firm.

Generally, a company's operations can be financed through debt and some form of equity financing.<sup>8</sup> Moreover, it is generally believed that a new or existing business needs to obtain both equity and debt financing if it is to have a sound financial foundation for growth without excessive dilution of the entrepreneur's equity.

Short-term debt (i.e., debt incurred for one year or less) usually is used by a business for working capital and is repaid out of the proceeds of its sales. Longer-term borrowings (i.e., term loans of one to five years or long-term loans maturing in more than five years) are used for working capital and/or to finance the purchase of property or equipment that serve as collateral for the loan. Equity financing is used to fill the non-bankable gaps, preserve ownership, and lower the risk of loan defaults.

However, a new venture just starting operations will have difficulty obtaining either short-term or longer-term bank debt without a substantial cushion of equity financing or long-term debt that is subordinated or junior to all bank debt.<sup>9</sup> As far as a lender is concerned, a start-up has little proven capability to generate sales, profits, and cash to pay off short-term debt and even less ability to sustain profitable operations over a number of years and retire long-term debt. Even the underlying protection provided by a venture's assets used as loan collateral may be insufficient to obtain bank loans. Asset values can erode with time; in the absence of adequate equity capital and good management, they may provide little real loan security to a bank.

A bank may lend money to a start-up to some maximum debt-to-equity ratio. As a rough rule, a start-up may be able to obtain debt for working capital purposes that is equal to its equity and subordinated debt. A start-up can also obtain loans through such avenues as Business Development Bank of Canada, manufacturers and suppliers, or leasing.

An existing business seeking expansion capital or funds for a temporary use has a much easier job obtaining both debt and equity. Sources such as banks, professional investors, and leasing and finance companies often will seek out such companies and regard them as important customers for secured and unsecured short-term loans or as good investment prospects. Furthermore, an existing and expanding business will find it easier to raise equity capital from private or institutional sources and to raise it on better terms than the start-up.

Awareness of criteria used by various sources of financing—whether for debt, equity, or some combination of the two—that are available for a particular situation is central to devise a time-effective and cost-effective search for capital.

### Financial Life Cycles

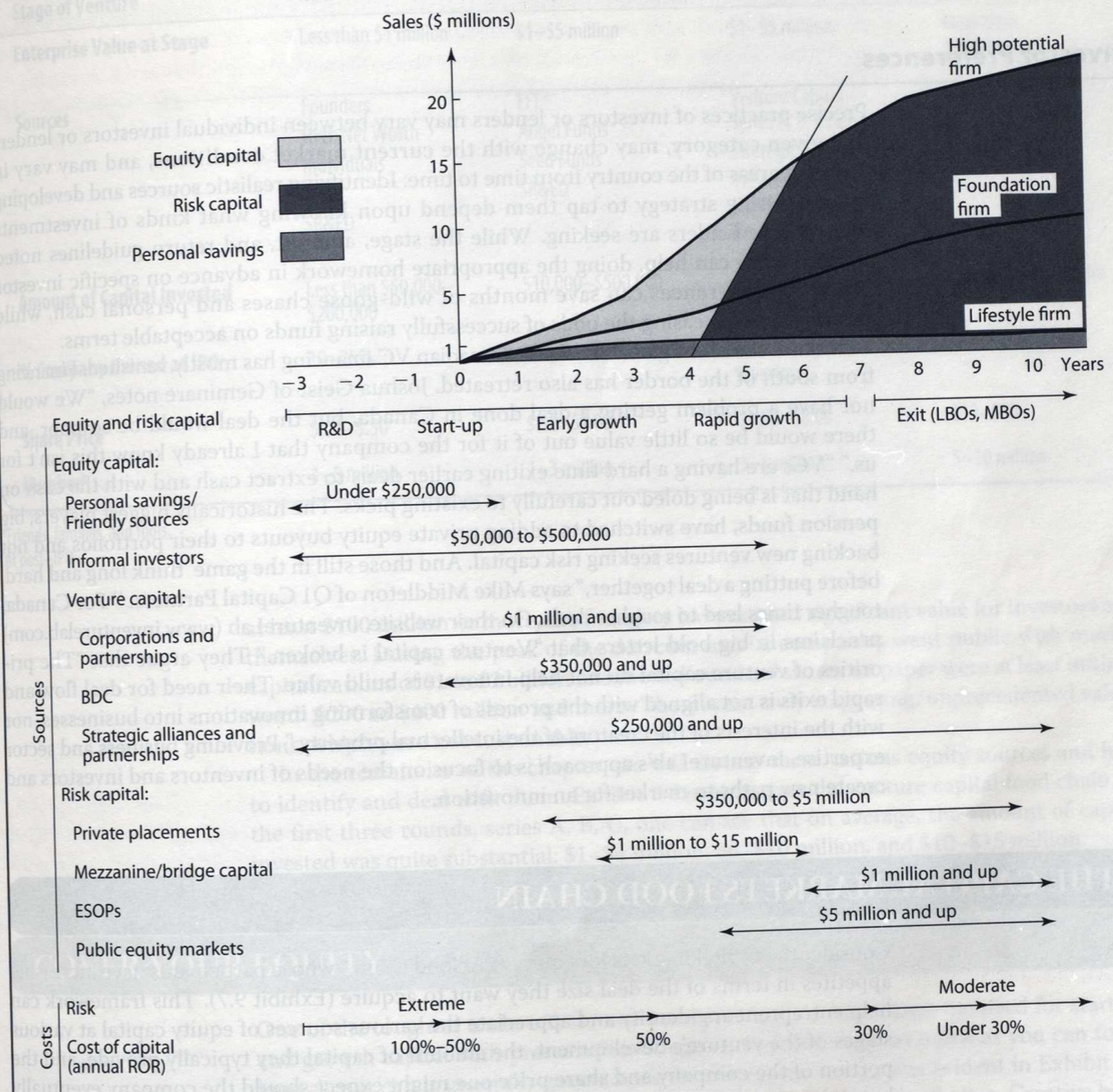
One useful way to begin identifying equity financing alternatives, and when and if certain alternatives are available, is to consider what can be called the financial life cycle of firms. Exhibit 9.6 shows the types of capital available over time for different types of firms at different stages of development (i.e., as indicated by different sales levels).<sup>10</sup> It also summarizes, at different stages of development (research and development, start-up, early growth, rapid growth, and exit), the principal sources of risk capital and costs of risk capital.

As can be seen in the exhibit, sources have different preferences and practices, including how much money they will provide, when in a company's life cycle they will invest, and the cost of the capital or expected annual rate of return they are seeking. The available sources of capital change dramatically for companies at different stages and rates of growth, and there will be variations in different parts of the country.

Many of the sources of equity are not available until a company progresses beyond the earlier stages of its growth. Some sources available to early-stage companies, especially personal sources, friends, and other informal investors or angels, will be insufficient to meet the financing requirements generated in later stages if the company continues to grow successfully.

Another key factor affecting the availability of financing is the upside potential of a company. Of the new businesses of all kinds expected to launch in Canada in the coming year, probably 5 percent or fewer will achieve the growth and sales levels of high potential

EXHIBIT 9.6 Financing Life Cycles



Source: Adapted and updated from W. H. Wetzel, Jr., "The Cost and Availability of Credit and Risk Capital in New England," in *A Region's Struggling Savior: Small Business in New England*, J. A. Timmons and D. E. Gumpert, eds. (Waltham, MA: Small Business Foundation of America, 1979).

firms. Foundation firms will total about 8 to 12 percent of all new firms, which will grow more slowly but exceed \$1 million in sales and may grow to \$5 to \$15 million. Remaining are the traditional, stable lifestyle firms. High potential firms (those that grow rapidly and are likely to exceed \$20 to \$25 million or more in sales) are strong prospects for a public offering and have the widest array of financing alternatives, including combinations of debt and equity and other alternatives (which are noted later), while foundation firms have fewer, and lifestyle firms are limited to the personal resources of their founders and whatever net worth or collateral they can accumulate.

In general, investors believe the younger the company, the more risky the investment. This is a variation of the old saying in the venture capital business: The lemons ripen in two-and-a-half years, but the plums take seven or eight.

While the timeline and dollar limits shown are only guidelines, they do reflect how these money sources view the riskiness, and thus the required rate of return, of companies at various stages of development.

### Investor Preferences

Precise practices of investors or lenders may vary between individual investors or lenders in a given category, may change with the current market conditions, and may vary in different areas of the country from time to time. Identifying realistic sources and developing a fund-raising strategy to tap them depend upon knowing what kinds of investments investors or lenders are seeking. While the stage, amount, and return guidelines noted in Exhibit 9.6 can help, doing the appropriate homework in advance on specific investor or lender preferences can save months of wild-goose chases and personal cash, while significantly increasing the odds of successfully raising funds on acceptable terms.

In the wake of the global recession, Canadian VC financing has mostly vanished. Financing from south of the border has also retreated. Joshua Geist of Geminare notes, "We would not have a problem getting a deal done in Canada, but the deal would be so poor, and there would be so little value out of it for the company that I already know this isn't for us." "VCs are having a hard time exiting earlier deals to extract cash and with the cash on hand that is being doled out carefully to existing picks. The historically biggest players, big pension funds, have switched to adding private equity buyouts to their portfolios and not backing new ventures seeking risk capital. And those still in the game 'think long and hard' before putting a deal together," says Mike Middleton of Q1 Capital Partners.<sup>11</sup> For Canada, tougher times lead to tougher deals. On their website, *inventureLab* ([www.inventurelab.com](http://www.inventurelab.com)) proclaims in big bold letters that "Venture capital is broken." They argue that "The priorities of venture capital do not help innovators build value. Their need for deal flow and rapid exits is not aligned with the process of transforming innovations into businesses, nor with the interests of the creators of the intellectual property." Providing business and sector expertise, *inventureLab*'s approach is to focus on the needs of inventors and investors and create new paths to market for an innovation.

## THE CAPITAL MARKETS FOOD CHAIN

Consider the capital markets for equity as a "food chain," whose participants have increasing appetites in terms of the deal size they want to acquire (Exhibit 9.7). This framework can help entrepreneurs identify and appreciate the various sources of equity capital at various stages of the venture's development, the amount of capital they typically provide, and the portion of the company and share price one might expect should the company eventually have an initial public offering (IPO) or trade sale.

The bottom row in Exhibit 9.7 shows this ultimate progression from R&D stage to IPO, where the capital markets are typically willing to pay \$12 to \$18 per share for new issues of small companies. Obviously, these prices are lower when the so-called IPO window is tight or closed, such as after the dot-com bubble. Prices for the few offerings that did exist (1 to 3 per week versus more than 50 per week in June 1996) were \$5 to \$9 per share. In hot IPO periods, 1999 for instance, offering prices reached as high as \$20 per share and more. The modest revival that began in late 2003 continued into 2005. More recently, again the IPO markets suffered a severe decline and were basically shut down after the market trouble and economic turmoil beginning in late 2008, continuing through 2009 and well into 2010. In the third quarter of 2008 no private companies went public in Canada—no IPOs at all. In the first half of 2008 there were 53 public equity issues sold to Canadian investment markets with a value of \$680 million—a fraction of what occurred in the boom years between 1996 and 1999.

One of the toughest decisions for the founders is whether to give up equity, and implicitly control, to have a run at creating very significant value. The row, "% company owned at IPO," shows that by the time a company goes public, the founders may have sold 70 to 80 percent or more of their equity. As long as the market capitalization of the company is

### EXHIBIT 9.7 The Capital Markets Food Chain for Entrepreneurial Ventures

Stage of Venture	R&D	Seed	Launch	High Growth
<b>Enterprise Value at Stage</b>	Less than \$1 million	\$1–\$5 million	\$1–\$5 million	More than \$100 million
<b>Sources</b>	Founders High Net Worth Individuals FFF* SR&ED	FFF* Angel Funds Seed Funds SR&ED	Venture Capital Series A, B, C... Strategic Partners Very High Net Worth Individuals Private Equity	IPOs Strategic Acquirers Private Equity
<b>Amount of Capital Invested</b>	Less than \$50,000– \$200,000	\$10,000–\$500,000	\$500,000– \$20 million	\$10–\$50 million-plus
<b>% Company Owned at IPO</b>	10–25%	5–15%	40–60% by prior investors	15–25% by public
<b>Share Price</b>	\$.01–\$.50	\$.50–\$1.00	\$1.00–\$8.00	\$12–\$18
<b>Number<sup>†</sup></b>	1–5 million	1–3 million	3–5 million	5–10 million

\*Friends, families, and fools.

<sup>†</sup>At post-IPO

at least \$100 million or more, the founders have created significant value for investors and themselves. During the peak of the dot-com mania, companies went public with market capitalizations of \$1 to \$2 billion and more. Founders' shares on paper were at least initially worth \$200 to \$400 million and more. These were truly staggering, unprecedented valuations, which were not sustainable.

In the remainder of the chapter, we will discuss these various equity sources and how to identify and deal with them. Exhibit 9.8 summarizes the venture capital food chain. In the first three rounds, series A, B, C, one can see that on average, the amount of capital invested was quite substantial: \$1–\$4 million, \$6–\$10 million, and \$10–\$15 million.

### COVER YOUR EQUITY

One of the toughest trade-offs for any young company is to balance the need for start-up and growth capital with preservation of equity. Holding on to as much as you can for as long as you can is generally good advice for entrepreneurs. As was evident in Exhibit 9.6, the earlier the capital enters, regardless of the source, the more costly it is. Creative bootstrapping strategies can be great preservers of equity, as long as such parsimony does not slow the venture's progress so much that the opportunity weakens or disappears.

### EXHIBIT 9.8 The Venture Capital Food Chain for Entrepreneurial Ventures

Venture Capital Series A, B, C, ... (Average size of round): Example of three staged rounds

Round <sup>†</sup>	{	"A" @ \$1–4 million—Start-up
		"B" @ \$6–10 million—Product development
		"C" @ \$10–15 million—Shipping product

\*Valuations vary markedly by industry.

\*\*Valuations vary by region and venture capital cycle.

Three central issues should be considered when beginning to think about obtaining risk capital: (1) Does the venture need outside equity capital? (2) Do the founders want outside equity capital? and finally, (3) Who should invest? While these three issues are at the centre of the management team's thinking, it is also important to remember that a smaller percentage of a larger pie is preferred to a larger percentage of a smaller pie. Or as one entrepreneur stated, "I would rather have a piece of a watermelon than a whole raisin."<sup>12</sup>

After reviewing the online Venture Opportunity Screening Exercises, the business plan for Chapter 4, and the free cash flow equations (including OOC, TTC, and breakeven) from earlier in this chapter, it may be easier to assess the need for additional capital. Deciding whether the capital infusion will be debt or equity is situation specific, and it may be helpful to be aware of the trade-offs involved; see Chapter 11 for an introduction to debt capital. In the majority of the high-technology start-ups and early-stage companies, some equity investment is normally needed to fund research and development, prototype development and product marketing, launch, and early losses.

Once the need for additional capital has been identified and quantified, the management team must consider the desirability of an equity investment. As was mentioned in Chapter 8, bootstrapping continues to be an attractive source of financing. Many entrepreneurs suggest getting customers to pay quickly.<sup>13</sup> Entrepreneurs in certain industries can tap vendors by getting them to extend credit.<sup>14</sup> Such credit is termed "spontaneous" financing and arises in the normal course of business activity. While it may appear a blessing at the time, tables can turn. Air Canada is "perilously close to violating debt covenants. When its cash holdings fall below \$900 million, for example, its credit card processing company can withhold a portion of ticket sales."<sup>15</sup> And the threshold is expected to rise to \$1.3 billion—while its current reserves hover around \$1 billion. Standard and Poor's recently downgraded the airline's debt, adding greater pressure.

An equity investment requires that the management team firmly believes that investors can and will add value to the venture. With this belief, the team can begin to identify those investors who bring expertise to the venture. Cash flow versus high rate of return required is an important aspect of the "equity versus other" financing decision.

Deciding *who* should invest is a process more than a decision. The management team has a number of sources to consider. There are both informal and formal investors, private and public markets. The single most important criterion for selecting investors is what they can contribute to the value of the venture—beyond just funding. Angels or wealthy individuals are often sought because the amount needed may be less than the minimum investment required by formal investors (i.e., venture capitalists and private placements). Whether a venture capitalist would be interested in investing can be determined by the amount needed and the rate of return expected.

## TIMING

*There are two times for a young company to raise money; when there is lots of hope, or lots of results, but never in between.*

Georges Doriot  
Venture Capitalist

Timing is also critical. **A venture should not wait to look for capital until it has a serious cash shortage.** For a start-up, especially one with no experience or success in raising money, it is unwise to delay seeking capital because it is likely to take six months or more to raise money. In addition to the problems with cash flow, the lack of planning implicit in waiting until there is a cash shortage can undermine the credibility of a venture's management team and negatively impact its ability to negotiate with investors.

But if a venture tries to obtain equity capital too early, the equity position of the founders may be unnecessarily diluted and the discipline instilled by financial leanness may be eroded inadvertently.

## ANGELS AND INFORMAL INVESTORS

### Who They Are

**Wealthy individuals are an important source of capital for start-up and emerging businesses today.** They have made it on their own, have substantial business and financial experience, and are likely to be in their 40s or 50s. They are also well educated; 95 percent hold university degrees, and 51 percent have graduate degrees. Of the graduate degrees, 44 percent are in a technical field and 35 percent are in business or economics.

Since the typical informal investor will invest from \$10,000 to \$250,000 in any one deal, informal investors are particularly appropriate for the following:<sup>16</sup>

- Ventures with capital requirements of between \$50,000 and \$500,000.
- Ventures with sales potential of between \$2 and \$20 million within 5 to 10 years.
- Small, established, privately held ventures with sales and profit growth of 10 to 20 percent per year, a rate that is not rapid enough to be attractive to a professional investor, such as a venture capital firm.
- Special situations, such as very early financing of high-technology inventors who have not developed a prototype.
- Companies that project high levels of free cash flow within three to five years.

**These investors may invest alone or in syndication with other wealthy individuals, may demand considerable equity for their interests, or may try to dominate ventures.** They also can get very impatient when sales and profits do not grow as they expected.

Usually, these informal investors will be knowledgeable and experienced in the market and technology areas in which they invest. If the right angel is found, he or she will add a lot more to a business than just money. As an advisor or director, his or her savvy, know-how, and contacts that come from having "made it" can be far more valuable than the \$10,000 to \$250,000 invested. The New Brunswick Small Business Investor Tax Credit gives a 30-percent tax break on investment amounts up to \$80,000. The Yukon Small Business Investment Tax Credit grants a 24-percent break on investments of \$100,000 or less. Generally, the evaluations of potential investments by such wealthy investors tend to be less thorough than those undertaken by organized venture capital groups, and such non-economic factors as the desire to be involved with entrepreneurship may be important to their investment decisions. There is a clear geographic bias of working within a one-hour driving radius of the investor's base. For example, a successful entrepreneur may want to help other entrepreneurs get started, or a wealthy individual may want to help build new businesses in his or her community.

### Finding Informal Investors

Finding these backers is not easy. One expert noted: "Informal investors, essentially individuals of means and successful entrepreneurs, are a diverse and dispersed group with a preference for anonymity. Creative techniques are required to identify and reach them."<sup>17</sup> The Internet has provided entrepreneurs with an effective method of locating such investors. Formal sources such as Garage Technology Ventures and Brightspark Capital provide invaluable advice, assistance, and information regarding potential investors and help forge the link between investors and entrepreneurs seeking capital.

**Invariably, financial backers are also found by tapping an entrepreneur's own network of business associates and other contacts.** Other successful entrepreneurs know them, as do many tax attorneys, accountants, bankers, and other professionals. Apart from serendipity, the best way to find informal investors is to seek referrals from lawyers, accountants, business associates, university faculty, and entrepreneurs who deal with new ventures and are likely to know such people. Because such investors learn of investment opportunities from their business associates, fellow entrepreneurs, and friends, and because many informal investors invest together in a number of new venture situations, one informal investor contact can lead the entrepreneur to contacts with others.

In most larger cities, there are law firms and private placement firms that syndicate investment packages as offerings to networks of private investors. They may raise from several hundred thousand dollars to several million. The National Angel Capital Organization ([www.angelinvestor.ca](http://www.angelinvestor.ca)) is the national clearinghouse and lists 25 angel networks, but many angels fly under the radar. New Brunswick has only one readily identifiable angel network, which is not even included in the national registry. That New Brunswick angel network counts 25 individual angels, which completed two deals in 2007 for \$1.1 million.<sup>18</sup> Manitoba, Newfoundland and Labrador, Quebec, and Saskatchewan each have only one network identified in the NACO directory.

### Contacting Investors

If an entrepreneur has obtained a referral, he or she needs to get permission to use the name of the person making a referral when the investor is contacted. A meeting with the potential investor then can be arranged. At this meeting, the entrepreneur needs to make a concise presentation of the key features of the proposed venture by answering the following questions:

- What is the market opportunity?
- Why is it compelling?
- How will/does the business make money?
- How soon can the business reach positive cash flow?
- Why is this the right team at the right time?
- How does an investor exit the investment?

After the dot-com crash, investors throughout the capital markets food chain returned to these fundamental basics for evaluating potential deals. And the drought following the financial meltdown in late 2008 was expected to subside as investors cautiously test the waters once again in 2010 and generate confidence and momentum.

Entrepreneurs need to avoid meeting with more than one informal investor at the same time. Meeting with more than one investor often results in any negative viewpoints raised by one investor being reinforced by another. It is also easier to deal with negative reactions and questions from only one investor at a time. **Like a wolf on the hunt, if an entrepreneur isolates one target "prey" and then concentrates on closure, he or she will increase the odds of success.**

Whether or not the outcome of such a meeting is continued investment interest, the entrepreneur needs to try to obtain the names of other potential investors from this meeting. If this can be done, the entrepreneur will develop a growing list of potential investors and will find his or her way into one or more networks of informal investors. If the outcome is positive, often the participation of one investor who is knowledgeable about the product and its market will trigger the participation of other investors.

### Evaluation Process

An informal investor will want to review a business plan, meet the full management team, see any product prototype or design that may exist, and so forth. The investor will conduct background checks on the venture team and its product potential, usually through someone he or she knows who knows the entrepreneur and the product. The process is not dissimilar to the due diligence of the professional investors (see below) but may be less formal and structured. The new venture entrepreneur, if given a choice, would be wise to select an informal investor who can add knowledge, wisdom, and networks as an advisor and whose objectives are consistent with those of the entrepreneur.

### The Decision

If the investor decides to invest, he or she will have an investment agreement drafted by an attorney. This agreement may be somewhat simpler than those used by professional investors, such as venture capital firms. All the cautions and advice about investors and investment agreements that are discussed later in the chapter apply here as well.

Most likely, the investment agreement with an informal investor will include some form of a "put," whereby the investor has the right to require the venture to repurchase his or her stock after a specified number of years at a specified price. If the venture is not harvested, this put will provide an investor with a cash return.

For access to important documents for venture agreements, please visit the Online Learning Centre ([www.mcgrawhill.ca/olc/timmons](http://www.mcgrawhill.ca/olc/timmons)) for downloadable sample term sheets.

#### Will It Float?

Late-night television host, David Letterman, had a segment testing various items to see if they would float. To much fanfare, the item would be presented, analyzed, and a verdict would be reached before being dropped in a large tank of water for the real test. The verdict is still out on whether or not these entrepreneurs and their ideas will receive funding.

#### A BETTER MOUSETRAP

Frank Naumman of Waterloo, Ontario, has added a light emitting diode to his mousetrap as an indicator of whether or not it has been triggered. Although the modern mousetrap has been around since at least the 1880s, the last patent filing for an improved mousetrap was in 1993.<sup>19</sup>

#### ENERGY GENERATOR

Thane Heins of Almonte, Ontario, has developed "Perepeteia" what some say may be a perpetual motion machine. While these claims may be grandiose, the efficiency of his generator has caught the attention of scientists, the YouTube community, and at least one investor.<sup>20</sup>

#### DRYWALL FASTENER

Sean Ledoux of North Bay, Ontario, has come up with the idea of a single broad-headed screw to attach two drywall sheets to a wall instead of two screws, one on each side of the seam. He also has modified the screw threads but won't reveal details. Sean is already in talks to license the invention to Robertson Inc.—the founder of which lays claim to the creation of the square-notched screw.<sup>21</sup>

#### MASCARA REMOVER

Robyn Mumford of Cobourg, Ontario, has designed a device that removes mascara just from the eyelashes without having to rub the sensitive skin around the eyes. Though the potential is huge, Anthony Gussin of Nytric, an innovation consulting company—points out that it will take "considerable financial resources to develop."<sup>22</sup>

#### TRAILER HITCH ALIGNER

Ortwin Groh of Chilliwak, British Columbia, has developed a trailer-hitch alignment system to aid in backing up a vehicle in order to make proper contact to attach a trailer before towing. One piece attaches to the vehicle's bumper and another piece attaches to the trailer and then the driver lines them up in the mirrors while backing up the vehicle.<sup>23</sup>

**TRAILER HITCH ALIGNER**

Dave Underwood of London, Ontario, has the "Hitch Docker" to quickly, easily, efficiently line up and hook up a trailer with no damage to your bumper—guaranteed.<sup>24</sup> He has already had success across Ontario and his product is available through several specialty Internet firms based in the United States, but Dave is still seeking backing to make it big (e.g., Canadian Tire and Wal-Mart).

**TRAILER HITCH ALIGNER**

Jack Julicher of Bowmanville, Ontario, has patented the "Easy-Hitch" to "allow you to safely, and without hassle, hitch up any type of trailer system to your vehicle."<sup>25</sup> One telescopic rod with flashing light attached to the hitch-ball on the vehicle while another telescopic rod with flashing light attaches to the trailer. This permits visibility to insure alignment while backing up the vehicle. Jack and his wife were featured on *Dragons' Den* on CBC Television.

Sources: Joe Castaldo, "The Next Great Canadian Idea: A Better Mousetrap," *Canadian Business*, July 11, 2008; Sharda Prasad, "The Next Great Canadian Idea: Peripiteia Generator," *Canadian Business*, July 11, 2008; Andrew Wahl, "Semifinalist 3: Drywall Fastener," *Canadian Business*, June 4, 2007; Zena Olijnyk, "Semifinalist 2: Mascara Remover," *Canadian Business*, June 4, 2007; Joe Castaldo, "Semifinalist 1: Trailer Hitch Aligner," *Canadian Business*, June 4, 2007; www.hitchdocker.com; www.easyhitch.net.

**VENTURE CAPITAL: GOLD MINES AND TAR PITS**

There are only two classes of investors in new and young private companies: value-added investors and all the rest. If all you receive from an investor, especially a venture capitalist or a substantial private investor, is money, then you may not be getting a bargain. One of the keys to raising risk capital is to seek investors who will truly add value to the venture well beyond the money. Research and practice show that investors may add or detract value in a young company. Therefore, carefully screening potential investors to determine how they might fill some gaps in the founders' know-how and networks can yield significant results. Adding key management, new customers or suppliers, or referring additional investment are basic ways to add value.

A young founder of an international telecommunications venture landed a private investor who also served as an advisor. The following are examples of how this private investor provided critical assistance: introduced the founder to other private investors, to foreign executives (who became investors and helped in a strategic alliance), to the appropriate legal and accounting firms; served as a sounding board in crafting and negotiating early rounds of investments; and identified potential directors and other advisors familiar with the technology and relationships with foreign investors and cross-cultural strategic alliances.

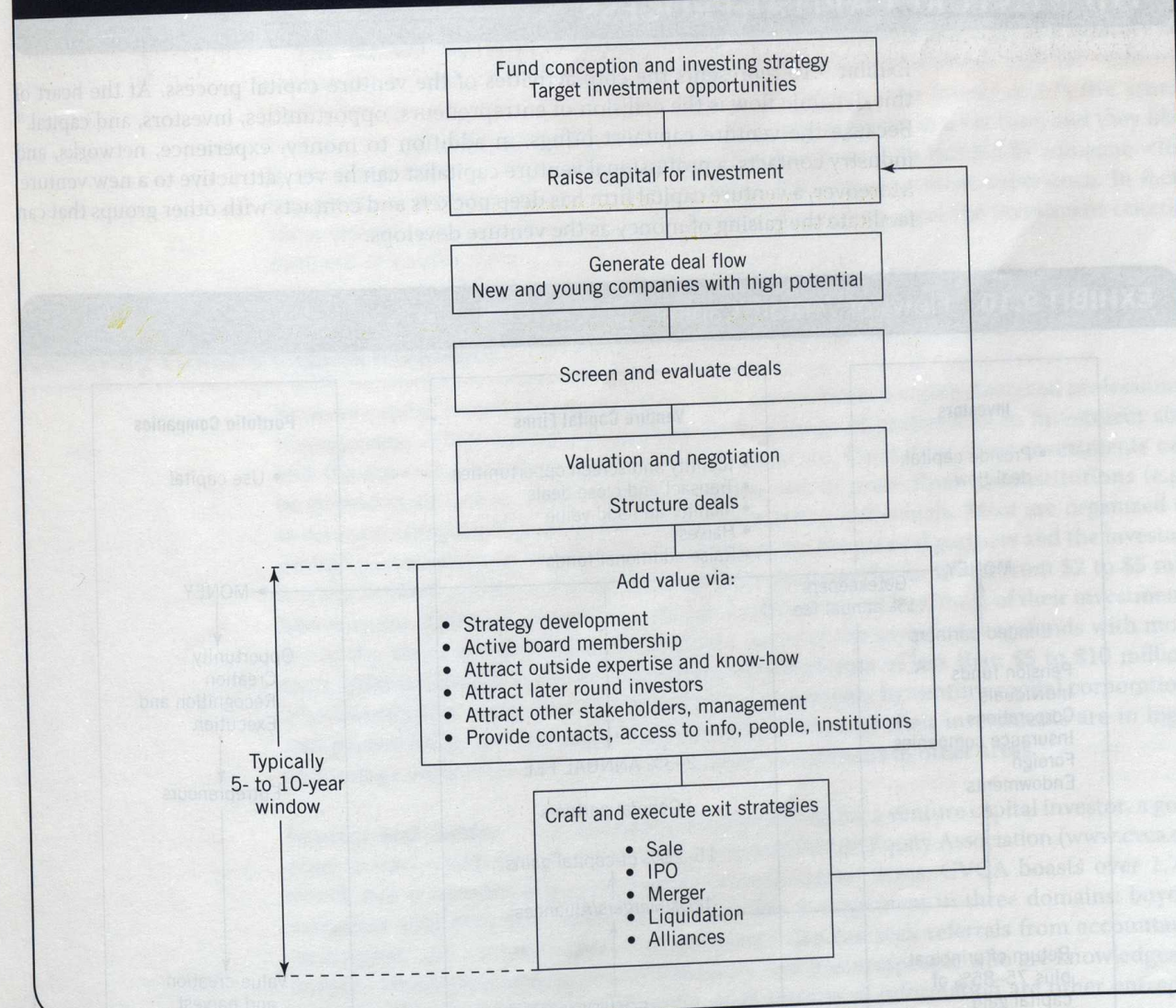
Numerous other examples exist of venture capitalists' being instrumental in opening doors to key accounts and vendors that otherwise might not take a new company seriously. Venture capitalists may also provide valuable help in such tasks as negotiating original equipment manufacturer (OEM) agreements or licensing or royalty agreements, making key contacts with banks and leasing companies, finding key people to build the team, helping to revise or to craft a strategy.

It is always tempting for an entrepreneur desperately in need of cash to go after the money that is available, rather than wait for the value-added investor. These quick solutions to the cash problem usually come back to haunt the venture.

**WHAT IS VENTURE CAPITAL?<sup>26</sup>**

The word *venture* suggests that this type of capital involves a degree of risk and even something of a gamble. Specifically, "The venture capital industry supplies capital and other resources to entrepreneurs in business with high growth potential in hopes of achieving a high rate of return on invested funds."<sup>27</sup> The whole investing process involves many stages, which are represented in Exhibit 9.9. Throughout the investing process, venture capital firms seek to add value in several ways: identifying and evaluating business opportunities, including management, entry, or growth strategies; negotiating and closing the investment; tracking and coaching the company; providing technical and management assistance; and attracting additional capital, directors, management, suppliers, and other key stakeholders and resources.

The process begins with the conception of a target investment opportunity or class of opportunities, which leads to a written proposal or prospectus to raise a venture capital fund. Once the money is raised, the value creation process moves from generating deals to crafting and executing harvest strategies and back to raising another fund. The process usually takes up to 10 years to unfold, but exceptions in both directions often occur.

**EXHIBIT 9.9** Venture Capital Investing Process

Source: William D. Bygrave and Jeffrey A. Timmons, *Venture Capital at the Crossroads* (Boston, MA: Harvard Business School Publishing, 1992).

## THE VENTURE CAPITAL INDUSTRY

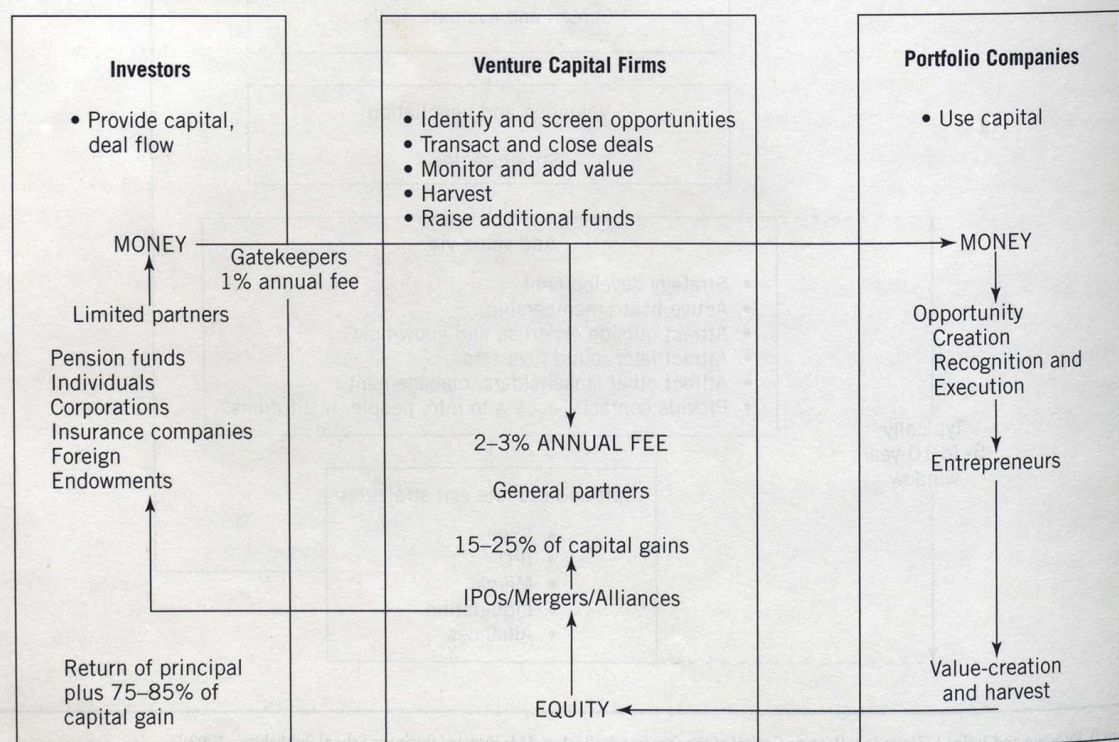
Although the roots of venture capital can be traced from investments made by wealthy families in the 1920s and 1930s, the venture capital industry did not experience a growth spurt until the 1980s, when the industry took off. Before 1980, venture capital investing activities could be called dormant; but in the 1980s the industry roared up. The sleepy cottage industry of the 1970s was transformed into a vibrant, at times frenetic, occasionally myopic, and dynamic market for private risk and equity capital in the 1980s. And it was deals galore through the 1990s with year after year reaching ever-higher levels through 2000. A sobering wake-up came in 2001 and the brakes came on hard in the ensuing years. Due diligence increased to six or eight months, closer to historical norms, rather than the 45 days or less during the dot-com feeding frenzy. Things gained momentum and in subsequent years the money started to flow once again—until everything came apart with the economic turmoil that began in late 2008 and continued on into 2010.

The stark reality of all this is that the venture capital cycle—much like real estate—seems to repeat itself. Scarcity of capital leads to high returns, which attracts an overabundance of new capital, which drives returns down. The meltdown side of the venture capital and private equity markets can be expected with the certainty—though fortunately not frequency—as the change of seasons.

## THE VENTURE CAPITAL PROCESS

Exhibit 9.10 represents the core activities of the venture capital process. At the heart of this dynamic flow is the collision of entrepreneurs, opportunities, investors, and capital.<sup>28</sup> Because the venture capitalist brings, in addition to money, experience, networks, and industry contacts, a professional venture capitalist can be very attractive to a new venture. Moreover, a venture capital firm has deep pockets and contacts with other groups that can facilitate the raising of money as the venture develops.

EXHIBIT 9.10 Flows of Venture Capital



The venture capital process occurs in the context of mostly private, quite imperfect capital markets for new, emerging, and middle-market companies (i.e., those companies with \$5 to \$200 million in sales). The availability and cost of this capital depend on a number of factors:

- Perceived risk, in view of the quality of the management team and the opportunity.
- Industry, market, attractiveness of the technology, and fit.
- Upside potential and downside exposure.
- Anticipated growth rate.
- Age and stage of development.
- Amount of capital required.
- Founders' goals for growth, control, liquidity, and harvest.
- Fit with investors' goals and strategy.
- Relative bargaining positions of investors and founders given the capital markets at the time.

However, no more than 2 to 4 percent of those contacting venture capital firms receive financing from them. Despite the increase in funds in the recent boom years, observers comment that the repeat fund-raisers "stay away from seed and early-stage investments largely because those deals tend to require relatively small amounts of capital, and the megafunds, with \$500 million-plus to invest, like to make larger commitments."<sup>29</sup> Further, an entrepreneur may give up 15 to 75 percent of his or her equity for seed/start-up financing. Thus, after several rounds of venture financing have been completed, an entrepreneur may own no more than 10 to 20 percent of the venture.

The venture capitalists' stringent criteria for their investments limit the number of companies receiving venture capital money. **Venture capital investors look for ventures with very high growth potential where they can quintuple their investment in five years;** they place a very high premium on the quality of management in a venture; and they like to see a management team with complementary business skills headed by someone who has previous entrepreneurial or profit-and-loss (P&L) management experience. In fact, these investors are searching for the "superdeal." Superdeals meet the investment criteria outlined in Exhibit 9.11.

## Identifying Venture Capital Investors

**Venture capital corporations or partners have an established capital base and professional management.** Their investment policies cover a range of preferences in investment size and the maturity, location, and industry of a venture. Capital for these investments can be provided by one or more wealthy families, one or more financial institutions (e.g., insurance companies or pension funds), and wealthy individuals. Most are organized as limited partnerships, in which the fund managers are the general partners and the investors are the limited partners. Today, most of these funds prefer to invest from \$2 to \$5 million or more. Although some of the smaller funds will invest less, most of their investments are in the range of \$500,000 to \$1.5 million. Some of the so-called megafunds with more than \$500 million to invest do not consider investments of less than \$5 to \$10 million. The investigation and evaluation of potential investments by venture capital corporations and partnerships are thorough and professional. Most of their investments are in high-technology businesses, but many will consider investments in other areas.

**Sources and Guides** If an entrepreneur is searching for a venture capital investor, a good place to start is with Canada's Venture Capital and Private Equity Association ([www.cvca.ca](http://www.cvca.ca)), which has a membership directory of venture capital firms. CVCA boasts over 1,700 members with over \$75 billion in capital under management in three domains: buyout, mezzanine, and venture capital. Entrepreneurs also can seek referrals from accountants, lawyers, investment and commercial bankers, and businesspeople who are knowledgeable about professional investors. Especially good sources of information are other entrepreneurs who have recently tried, successfully or unsuccessfully, to raise money.

**EXHIBIT 9.11** Characteristics of the Classic Superdeal from the Investor's Perspective**Mission**

- Build a highly profitable and industry-dominant market leading company.
- Go public or merge within four to seven years at a high price-earnings (P/E) multiple.

**Complete Management Team**

- Led by industry "superstar."
- Possess proven entrepreneurial, general management, and P&L experience in the business.
- Have leading innovator or technologies/marketing head.
- Possess complementary and compatible skills.
- Have unusual tenacity, imagination, and commitment.
- Possess reputation for high integrity.

**Proprietary Product or Service**

- Has significant competitive lead and "unfair" and sustainable or defensible advantages.
- Has product or service with high value-added properties resulting in early payback to user.
- Has or can gain exclusive contractual or legal rights.

**Large, Robust, and Sustainable Market**

- Will accommodate a \$100-million entrant in five years.
- Has sales currently at \$200 million, or more, and growing at 25% or more per year.
- Has no dominant competitor now.
- Has clearly identified customers and distribution channels.
- Possesses forgiving and rewarding economics, such as:
  - Gross margins of 40 to 50%, or more.
  - 10% or more profit after tax.
  - Early positive cash flow and breakeven sales.

**Deal Valuation and ROR**

- Has "digestible" first-round capital requirements (i.e., greater than \$1 million and less than \$10 million).
- Able to return 10 times original investment in five years at P/E of 15 times or more.
- Has possibility of additional rounds of financing at substantial mark-up.
- Has anti-dilution and IPO subscription rights and other identifiable harvest/liquidity options.

Source: William D. Bygrave and Jeffrey A. Timmons, *Venture Capital at the Crossroads* (Boston, MA: Harvard Business School Publishing, 1992).

Sometimes professional investors find entrepreneurs. Rather than wait for a deal to come to them, a venture capital investor may decide on a product or technology it wishes to commercialize and then put its own deal together. Michael Dunleavy and his fellow partners at Labarge Weinstein are always on the lookout for great companies to launch. They attend new technology showcases and other venues to discover the next great entrepreneurs who have not yet been called up to the big league.

**What to Look For** Entrepreneurs are well advised to screen prospective investors to determine the appetites of such investors for the stage, industry, technology, and capital requirements proposed. It is also useful to determine which investors have money to invest, which are actively seeking deals, and which have the time and people to investigate new deals. Depending on its size and investment strategy, a fund that is a year or two old will generally be in an active investing mode.

Early-stage entrepreneurs need to seek investors who (1) are considering new financing proposals and can provide the required level of capital; (2) are interested in companies at the particular stage of growth; (3) understand and have a preference for investments in the particular industry (i.e., market, product, technology, or service focus); (4) can provide good business advice, moral support, and contacts in the business and financial community; (5) are reputable, fair, and ethical and with whom the entrepreneur gets along; and (6) have successful track records of 10 years or more advising and building smaller companies.<sup>30</sup>

Entrepreneurs can expect a number of value-added services from an investor. Ideally, the investor should define his or her role as a coach, thoroughly involved, but not a player. In terms of support, investors should have both patience and bravery. The entrepreneur should be able to go to the investor when he or she needs a sounding board, counselling, or an objective, detached perspective. Investors should be helpful with future negotiations, financing, private and public offerings, as well as in relationship building with key contacts.

**What to Look Out For** There are also some things to be wary of in finding investors. These warning signs are worth avoiding unless an entrepreneur is so desperate that he or she has no real alternatives:

- *Attitude.* Entrepreneurs need to be wary if they cannot get through to a general partner in an investment firm and keep getting handed off to a junior associate, or if the investor thinks he or she can run the business better than the lead entrepreneur or the new venture team.
- *Overcommitment.* Entrepreneurs need to be wary of lead investors who indicate they will be active directors but who also sit on the boards of six to eight other start-up and early-stage companies or are in the midst of raising money for a new fund.
- *Inexperience.* Entrepreneurs need to be wary of dealing with venture capitalists who have an MBA; are under 30 years of age; have worked only on Bay Street or as a consultant; have no operating, hands-on experience in new and growing companies; and have a predominantly financial focus.
- *Unfavourable reputation.* Entrepreneurs need to be wary of funds that have a reputation for early and frequent replacement of the founders or those where more than one-fourth of the portfolio companies are in trouble or failing to meet projections in their business plans.
- *Predatory pricing.* During adverse capital markets, investors who unduly exploit these conditions by forcing large share price decreases in the new firms and punishing terms on prior investors do not make the best long-term financial partners.

**How to Find Out** How does the entrepreneur learn about the reputation of the venture capital firm? The best source is the CEO/founders of prior investments. Besides the successful deals, ask for the names and phone numbers of CEOs the firm invested in whose results were only moderate to poor, and where the portfolio company had to cope with significant adversity. Talking with these CEOs will reveal the underlying fairness, character, values, ethics, and potential of the venture capital firm as a financial partner, as well as how it practises its investing philosophies. It is always interesting to probe regarding the behaviour at pricing meetings.

**Dealing with Venture Capitalists<sup>31</sup>**

Don't forget that venture capitalists see lots of business plans and proposals, sometimes 100 or more a month. Typically, they invest in only one to three of these. The following suggestions may be helpful in working with them.

If possible, obtain a personal introduction from someone that is well-known to the investors (a director or founder of one of their portfolio companies, a limited partner in their fund, a lawyer or accountant who has worked with them on deals) and who knows you well. After identifying the best targets, you should create a market for your company by marketing it. Have several prospects. Be vague about who else you are talking with. You can end up with a rejection from everyone if the other firms know who was the first firm that turned you down. Beware, it is often just as hard to get a "no" as to get a "yes." You can waste an enormous amount of time before getting there.

When pushed by the investors to indicate what other firms/angels you are talking to, simply put it this way: "All our advisors believe that information is highly confidential to the company, and our team agrees. We are talking to other high quality investors like yourselves. The ones with the right chemistry who can make the biggest difference in our

company and are prepared to invest first will be our partner. Once we have a term sheet and deal on the table, if you also want co-investors we are more than happy to share these other investors' names." Failing to take such a tack usually puts you in an adverse negotiating position.

Most investors who have serious interest will have some clear ideas about how to improve your strategy, product line, positioning, and a variety of other areas. This is one of the ways they can add value—if they are right. Consequently, you need to be prepared for them to take apart your business plan and to put it back together. They are likely to have their own format and their own financial models. Working with them on this is a good way to get to know them.

Never lie. As one entrepreneur put it, "You have to market the truth, but do not lie." Do not stop selling until the money is in the bank. Let the facts speak for themselves. Be able to deliver on the claims, statements, and promises you make or imply in your business plan and presentations. Tom Huseby of SeaPoint Ventures adds some final wisdom: "It's much harder than you ever thought it could be. You can last much longer than you ever thought you could. They have to do this for the rest of their lives!" Finally, never say no to an offer price. There is an old saying that your first offer may be your best offer.

### Questions the Entrepreneur Can Ask

The presentation to investors when seeking venture capital is demanding and pressing, which is appropriate for this high-stakes game. Venture capitalists have an enormous legal and fiduciary responsibility to their limited partners, not to mention their powerful self-interest. Therefore, they are thorough in their due diligence and questioning to assess the intelligence, integrity, nimbleness, and creativity of the entrepreneurial mind in action (see Chapter 1).

Once the presentation and question-answer session is complete, the founders can learn a great deal about the investors and enhance their own credibility by asking a few simple questions:

- Tell us what you think of our strategy, how we size up the competition, and our game plan. What have we missed? Who have we missed?
- Are there competitors we have overlooked? How are we vulnerable and how do we compete?
- How would you change the way we are thinking about the business and planning to seize the opportunity?
- Is our team as strong as you would like? How would you improve this and when?
- Give us a sense of what you feel would be a fair range of value for our company if you invested \$\_\_\_\_\_?

Their answers will reveal how much they have done and how knowledgeable they are about your industry, technology, competitors, and the like. This will provide robust insight as to whether and how they can truly add value to the venture. At the same time, you will get a better sense of their forthrightness and integrity: Are they direct, straightforward, but not oblivious to the impact of their answers? Finally, these questions can send a very favourable message to investors: Here are entrepreneurs who are intelligent, open-minded, receptive, and self-confident enough to solicit our feedback and opinions even though we may have opposing views.

### Due Diligence: A Two-Way Street

It can take several weeks or even months to complete the due diligence on a start-up, although if the investors know the entrepreneurs, it can go much more quickly. The verification of facts, backgrounds, and reputations of key people, market estimates, technical capabilities of the product, proprietary rights, and the like is a painstaking investigation for investors. They will want to talk with your directors, advisors, former bosses, and previous partners. Make it as easy as possible for them by having very detailed résumés and lists of

10 to 20 references (with phone numbers and addresses) such as former customers, bankers, vendors, and so on, who can attest to your accomplishments. Prepare extra copies of published articles, reports, studies, market research, contract, or purchase orders, technical specifications, and the like that can support your claims.

One recent research project examined how 86 venture capital firms nationwide conducted their intensive due diligence. To evaluate the opportunity, the management, the risks, the competition, and to weigh the upside against the downside, firms spent from 40 to 400 hours, with the typical firm spending 120 hours. That is nearly three weeks of full-time effort. At the extreme, some firms engaged in twice as much due diligence.<sup>32</sup> Central to this investigation were careful checks of the management's references and verification of track record and capabilities.

While all this is going on, do your own due diligence on the venture fund. Ask for the names and phone numbers of some of their successful deals, some that did not work out, and the names of any presidents they ended up replacing. Who are their legal and accounting advisors? What footprints have they left in the sand regarding their quality, reputation, and record in truly adding value to the companies in which they invest? Finally, the chemistry between the management team and the general partner that will have responsibility for the investment and, in all likelihood, a board seat is crucial. If you do not have a financial partner you respect and can work closely with, then you are likely to regret ever having accepted the money.

## OTHER EQUITY SOURCES

### Business Development Bank of Canada (BDC)

Promoting small and medium-sized enterprises by guaranteeing long-term loans, venture capital, and subordinate financing, Business Development Bank of Canada has been supporting start-up and high-potential ventures since 1944 (see Exhibit 9.12). According to their Web site:

- **BDC Financing** clients accepted \$2.9 billion new loans through some 9,100 transactions. Income totalled \$160.9 million in fiscal 2008. The closing portfolio, before allowance for credit losses, rose to \$10.0 billion, an increase of \$886 million, or nearly 10 percent over 2007.
- **BDC Subordinate Financing** clients accepted \$97.4 million through 107 transactions executed by way of a limited partnership with the Caisse de dépôt et placement du Québec. BDC's share of the transactions accounted for \$48.7 million in fiscal 2008. As of March 31, 2008, BDC's Subordinate Financing portfolio stands at a fair value of \$156.2 million, a 5.3-percent increase over last year.
- **BDC Venture Capital** authorized 85 direct investments for a total of \$105.5 million. It also authorized investments of \$25 million in two funds.
- **BDC Consulting** revenues reached \$24.8 million. In 2008, 2,770 mandates were started. BDC Consulting offers entrepreneurs tailored, affordable, high-quality services to help them become more competitive.

Leading as a development bank, BDC pays special attention to start-ups, innovators, fast growth companies, manufacturers, and exporters who face lower financing approval rates. BDC also pays special attention to entrepreneurs who are working to commercialize the fruits of research and development—university or lab discoveries—to create innovative products and globally successful companies in sectors such as life sciences and information technology.

Over the past six years, about 14 percent of BDC authorizations went to clients in the start-up phase. Market data shows that approximately 5 percent of Canadian businesses are start-ups. BDC finds that after five years, 67 percent of the start-up businesses it supported survive, compared to the Statistics Canada industry benchmark of 36 percent.

**EXHIBIT 9.12** Business Development Bank of Canada

- BDC Venture Capital is a Canadian leader in the critically important early-stage (including seed) investment phase. In fiscal 2009, BDC made 58 percent of the dollar value of its direct investments in early-stage firms. That figure compares with the industry average of 44 percent. In 2009, direct seed investments in Canada totalled \$64.1 million.
- BDC offers subordinate financing, a hybrid financing that combines debt and equity features, to entrepreneurs who need working capital to grow their businesses but do not have the tangible security that conventional lenders require, or who do not want to dilute their ownership of the firm.
- Women entrepreneurs lead businesses of all sizes in all sectors. They also enter the small business marketplace at twice the rate men do. Over the past two decades, their number has more than doubled. BDC has more than 7,000 women clients, almost twice as many as it did a decade ago. Women represent about one quarter of BDC's client roster.
- Young entrepreneurs lead about 9 percent of Canadian small businesses. Many of them find it hard to secure financing because they have limited net worth, little or no managerial experience, and have no proven track record. In fiscal 2009, through 22 Entrepreneurship Centres across Canada, BDC granted \$190 million worth of loans to young entrepreneurs across the country.
- BDC maintains formal partnerships with more than 200 Community Futures Development Corporations, a cross-country network of contact points located mostly in rural areas. These partnerships enable BDC to reach entrepreneurs who live near these centres. Using this network, BDC supported more than 800 entrepreneurs in 2009.
- BDC helps promote economic development in Aboriginal communities through a grassroots approach called the Circle of Entrepreneurial Success. This strategy delivers management training, ongoing mentorship, and loans of \$5,000 to \$20,000, with terms that vary depending on the cash flow expectations for the project.

Source: Business Development Bank of Canada, Annual report 2009, [www.bdc.ca](http://www.bdc.ca).

**Scientific Research and Experimental Development Tax Credit Program**

The risk and expense of conducting serious research and development are often beyond the means of start-ups and small businesses. For about 25 years, the SR&ED federal tax incentive program has encouraged companies to invest in and pursue innovation, by offering tax credits of up to 35 percent on the first \$2 million of qualified expenditures and 20 percent on amounts over that cap. In addition, provincial incentives vary from nothing to 20 percent. The Canada Revenue Agency administers the program and receives claims from over 11,000 enterprises, three-quarters of whom are small with claims varying from \$20,000 to \$2 million.

**Corporate Venture Capital**

While corporate venture capitalists are similar to traditional VCs in that they look for promising young companies on the verge of a spike in sales, corporations tend to be more risk-averse and specialized. Business investing is highly cyclical in nature and follows a pattern of ebb and flow. Since investing in a relevant technology can reduce the costs of their own research and development, fit is usually an important aspect of the funding decision. When working with corporate funding sources, make sure you consider the corporation's philosophy and culture, as well as their investment track record with small businesses before agreeing to any deal.

**Mezzanine Capital**

At the point where the company has overcome many of the early-stage risks, it may be ready for mezzanine capital.<sup>33</sup> The term *mezzanine financing* refers to capital that is between senior debt financing and common stock. In some cases it takes the form of redeemable preferred stock, but in most cases it is subordinated debt that carries an equity "kicker" consisting of warrants or a conversion feature into common stock. This subordinated-debt capital has many characteristics of debt but also can serve as equity to underpin senior debt. It is generally unsecured, with a fixed coupon and maturity of 5 to 10 years. A number of variables are involved in structuring such a loan: the interest rate, the amount and form of the equity, exercise/conversion price, maturity, call features, sinking fund, covenants, and put/call options. These variables provide for a wide range of possible structures to suit the needs of both the issuer and the investor.

Offsetting these advantages are a few disadvantages to mezzanine capital compared to equity capital. As debt, the interest is payable on a regular basis, and the principal must be repaid, if not converted into equity. This is a large claim against cash and can be burdensome if the expected growth and/or profitability does not materialize and cash becomes tight. In addition, the subordinated debt often contains covenants relating to net worth, debt, and dividends.

Mezzanine investors generally look for companies that have a demonstrated performance record, with revenues approaching \$10 million or more. Because the financing will involve paying interest, the investor will carefully examine existing and future cash flow and projections.

Mezzanine financing is utilized in a wide variety of industries, ranging from basic manufacturing to high technology. As the name implies, however, it focuses more on the broad middle spectrum of business, rather than on high-tech, high-growth companies. Specialty retailing, broadcasting, communications, environmental services, distributors, and consumer or business service industries are more attractive to mezzanine investors.

**Private Placements**

Private placements are an attractive source of equity capital for a private company that for whatever reason has ruled out the possibility of going public. If the goal of the company is to raise a specific amount of capital in a short time, this equity source may be the answer. In this transaction, the company offers stock to a few private investors, rather than to the public as in a public offering. A private placement requires little paperwork compared to a public offering.

If the company's management team knows of enough investors, family, relatives, or acquaintances. Or the company may decide to have a broker circulate the proposal among a few investors who have expressed an interest in small companies. The following four groups of investors might be interested in a private placement:<sup>34</sup>

1. Let us say you manufacture a product and sell to dealers, franchisors, or wholesalers. These are the people who know and respect your company. Moreover, they depend on you to supply the product they sell. They might consider it to be in their interest to buy your stock if they believe it will help assure continuation of product supply, and perhaps give them favoured treatment if you bring out a new product or product improvement. One problem is when one dealer invests and another does not; can you treat both fairly in the future? Another problem is that a customer who invests might ask for exclusive rights to market your product in a particular geographical area, and you might find it hard to refuse.
2. A second group of prospective buyers for your stock are those professional investors who are always on the lookout to buy a good, small company in its formative years, and ride it to success. Very often, these sophisticated investors choose an industry and a particular product or service in that industry they believe will become hot and then focus 99 percent of their attention on the calibre of the management. If your management, or one key individual, has earned a high reputation as a star in management, technology, or marketing, these risk-minded investors tend to flock to that person. (The high-tech industry is an obvious example.) Whether your operation meets their tests for stardom as a hot field may determine whether they find your private placement a risk to their liking.
3. Other investors are searching for opportunities to buy shares of smaller growth companies in the expectation that the company will soon go public and they will benefit as new investors bid the price up, as often happens. For such investors, news of a private placement is a tip-off that a company is on the move and worth investigating, always with an eye on the possibility of its going public.
4. Private placements also often attract venture capitalists who hope to benefit when the company goes public or when the company is sold. To help ensure that happy development, these investors get seriously active at the level of the board of directors, where their skill and experience can help the company reach its potential.

## Initial Public Stock Offerings

Commonly referred to as an IPO, an initial public offering raises capital through provincially registered and underwritten sales of the company's shares. Numerous federal and provincial securities laws and regulations govern these offerings; thus, it is important that management consult with lawyers and accountants who are familiar with the current regulations.

In the past, such as during strong bull markets for new issues, it was possible to raise money for an early-growth venture or even for a start-up. These boom markets are easy to identify because the number of new issues jump astoundingly. The flip side is that sharp decreases follow just as quickly as investor enthusiasm grinds to a halt. In these more difficult financial environments, such as following the 2008 recession, the new-issues market became very quiet for entrepreneurial companies. As a result, exit opportunities are limited. In addition, it becomes very difficult to raise money for early-growth or even more mature companies from the public market.

The more mature a company is when it makes a public offering, the better the terms of the offering. A higher valuation can be placed on the company, and less equity will be given up by the founders for the required capital.

There are a number of reasons an entrepreneurial company would want to go public. The following are some of the advantages:

- To raise more capital with less dilution than occurs with private placements or venture capital.
- To improve the balance sheet and/or to reduce or to eliminate debt, thereby enhancing the company's net worth. To obtain cash for pursuing opportunities that would otherwise be unaffordable.
- To access other suppliers of capital and to increase bargaining power, as the company pursues additional capital when it needs it least.
- To improve credibility with customers, vendors, key people, and prospects. To give the impression: "You're in the big leagues now."
- To achieve liquidity for owners and investors.
- To create options to acquire other companies with a tax-free exchange of stock, rather than having to use cash.
- To create equity incentives for new and existing employees.

Notwithstanding the above, IPOs can be disadvantageous for a number of reasons:

- The legal, accounting, and administrative costs of raising money via a public offering are more disadvantageous than other ways of raising money.
- A large amount of management effort, time, and expense are required to comply with securities regulations and reporting requirements and to maintain the status of a public company. This diversion of management's time and energy from the tasks of running the company can hurt its performance and growth.
- Management can become more interested in maintaining the price of the company's stock and computing capital gains than in running the company. Short-term activities to maintain or increase a current year's earnings can take precedence over longer-term programs to build the company and increase its earnings.
- The liquidity of a company's stock achieved through a public offering may be more apparent than real. Without a sufficient number of shares outstanding and a strong "market maker," there may be no real market for the stock and, thus, no liquidity.
- The investment banking firms willing to take a new or unseasoned company public may not be the ones with whom the company would like to do business and establish a long-term relationship.

## Private Placement after Going Public<sup>35</sup>

Sometimes a company goes public and then, for any number of reasons that add up to bad luck, the high expectations that attracted lots of investors early on turn sour. Your financial picture worsens; there is a cash crisis; down goes the price of your stock in the public marketplace. You find that you need new funds to work your way out of difficulties, but public investors are disillusioned and not likely to cooperate if you bring out a new issue.

Still, other investors are sophisticated enough to see beyond today's problems; they know the company's fundamentals are sound. While the public has turned its back on you, these investors may be receptive if you offer a private placement to tide you over. In such circumstances, you may use a wide variety of securities—common stock, convertible preferred stock, convertible debentures. There are several types of exempt offerings, usually described by reference to the securities regulation that applies to them.

## Employee Stock Ownership Plans (ESOPs)

ESOPs are another potential source of funding used by existing companies that have high confidence in the stability of their future earnings and cash flow. An ESOP is a program in which the employees become investors in the company, thereby creating an internal source of funding. "The combination of being able to invest in employer stock and to benefit from its many tax advantages make the ESOP an attractive tool."<sup>36</sup> The ESOP Association of Canada claims that enterprises with ESOPs have higher profit growth, higher profit margins, increased productivity, and better returns on both total equity as well as capital ([www.esop-canada.com](http://www.esop-canada.com)).

## Keeping Current about Capital Markets

One picture is vivid from all this: Capital markets, especially for closely held, private companies right through the initial public offering, are very dynamic, volatile, asymmetrical, and imperfect. Keeping abreast of what is happening in the capital markets in the six to 12 months before a major capital infusion can save invaluable time and hundreds of thousands and occasionally millions of dollars. Below are listed the best sources currently available to keep you informed:

- ✓ Canada's Venture Capital & Private Equity Association ([www.cvca.ca](http://www.cvca.ca)).
- ✓ Guide for Canadian companies looking to access the U.S. capital markets ([www.osler.com/resources.aspx?id=11930](http://www.osler.com/resources.aspx?id=11930)).
- ✓ Raising Capital in Canada ([www.bowne.com/securitiesconnect/pubs\\_raising\\_capital.asp](http://www.bowne.com/securitiesconnect/pubs_raising_capital.asp)).
- ✓ *Venture Capital Journal* ([www.vcjnews.com](http://www.vcjnews.com)).
- ✓ *Red Herring*, a Silicon Valley magazine.

## Chapter Summary

1. Cash flow is king and cash is queen. Happiness is a positive cash flow. More cash is preferred to less cash. Cash sooner is preferred to cash later. Less-risky cash is preferred to more-risky cash.
2. Financial know-how, issues, and analysis are often the entrepreneurs' Achilles' heels.
3. Entrepreneurial finance is the art and science of quantifying value creation, slicing the value pie, and managing and covering financial risk.
4. Determining capital requirements, crafting financial and fund-raising strategies, and managing and orchestrating the financial process are critical to new venture success.
5. Harvest strategies are as important to the entrepreneurial process as value creation itself. Value that is unrealized may have no value.
6. Appreciating the capital markets as a food chain looking for companies to invest in is key to understanding motivations and requirements.
7. Entrepreneurs have to determine the need for outside investors, whether they want outside investors, and if so whom.
8. Canada's unique capital markets include a wide array of private investors, from "angels" to venture capitalists.
9. The search for capital can be very time consuming, and whom you obtain money from is more important than how much (i.e., identifying gold mines and avoiding tar pits).
10. It is said that the only thing that is harder to get from a venture capitalist than a "yes" is a "no."
11. Entrepreneurs who know what and whom to look for—and look out for—increase their odds for success.

## Study Questions

1. Define the following and explain why they are important: burn rate, free cash flow, OOC, TTC, financial management myopia, spreadsheet mirage.
2. Why is entrepreneurial finance simultaneously both the least and most important part of the entrepreneurial process? Explain this paradox.
3. What factors affect the availability, suitability, and cost of various types of financing? Why are these factors critical?
4. Why do financially savvy entrepreneurs ask the financial and strategic questions in Exhibit 9.1? Can you answer these questions for your venture?
5. What does one look for in an investor, and why?
6. How can the founders prepare for the due diligence and evaluation process?
7. Describe the venture capital investing process and its implications for fund-raising.
8. What other sources of capital are available and how are these accessed?
9. Explain the capital markets food chain and its implications for entrepreneurs and investors.

## Mind Stretchers *Have you considered?*

1. With regard to your new venture, to what extent might you be suffering from financial myopia and spreadsheet mirage?
2. People who believe that you first have to have money, in large amounts, to make money are naive and ignorant. Why is this so? Do you agree?
3. Who do you need to get to know well to strengthen the entrepreneurial finance know-how on your team?
4. Some entrepreneurs say you shouldn't raise venture capital unless you have no other alternative. Do you agree or disagree, and why?
5. Identify a founder/CEO who has raised outside capital, and was later fired by the board of directors. What are the lessons here?
6. How do venture capitalists make money? What are the economics of venture capital as a business?

## CASE SANDVINE INC.

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### Preparation Questions

1. Evaluate the company. How much do you believe the company is worth?
2. From an investor's perspective, please make specific recommendations regarding financing.
3. What specific actions would you propose be taken and when?

In late September 2003 Dave Caputo, president and CEO of Waterloo, Ontario-based Sandvine Inc., was considering what recommendations he should make at the upcoming senior management meeting. In business only 28 months, Sandvine had developed two exciting new products designed to increase the profitability of Internet Service Providers (ISPs). The first allowed ISPs to reduce costs by better managing the exploding volumes of peer-to-peer (P2P) network traffic they were forced to handle as a result of their subscribers' increasing use of P2P file sharing. The second provided a means for the ISPs to increase their revenues by offering their subscribers a suite of network-based services such as virus protection, content filtering, and firewalls, (i.e., subscriber services).

The company was scoring some important successes in the early-stage commercialization of its products, and had high hopes of delivering a 'home run' for its investors. But there were issues. Caputo was uncertain about the sustainability of heavy P2P-generated traffic volumes in light of a growing propensity among copyright holders to take legal action against unauthorized copying of music files. At the same time, he was becoming increasingly concerned about Sandvine's ability to compete in the subscriber services arena in the face of large, well-known competition.

At the senior management meeting scheduled for October 2, Caputo wanted to outline his suggestions to the team about the way forward. Before he could do this, though, he needed to answer some important strategic questions. Should Sandvine remain committed to both product areas, should they focus on just one (and if so, which one), or should they pursue a third, as yet unknown alternative? Overlaid on these concerns was the question of geographic expansion. With sales offices in Europe, and a new office just opened in Hong Kong, were they over-stretching their limited resources, or was it crucial to aggressively pursue quick worldwide adoption of Sandvine's unique technology?

### Background

Sandvine's origins could be traced back to 1997, when video networking equipment maker PixStream was started in Waterloo, Ontario, with just \$3 million of seed money. PixStream was so successful that it was sold to Cisco Systems for \$554 million just as the tech bubble burst in 2001. Cisco shut down

PixStream four months later, with a layoff of 220 staff, as part of a massive global restructuring. The layoffs were especially troubling to Caputo, who had known many of the staff since the company's birth. Young engineers and tech workers who had started out in sneakers and t-shirts had now developed and matured. Increasingly, family portraits were replacing Smashing Pumpkins posters at their cubicles. More importantly, many of these folks were talented people who had been responsible for the dazzling success of PixStream.

Caputo was not the only one concerned about the breakup of the talented PixStream team. Within hours of Cisco announcing the closure of PixStream, Caputo had received a call from one of the original PixStream investors. His question was simple: "What are you going to do, Dave, to keep the team together?" Caputo's response was to huddle with four other PixStream leaders to see what could be done. With the blessing of Cisco and in advance of PixStream's closure, the team met with venture capital groups (VCs) to plant the seeds for what would ultimately become Sandvine. Within weeks, Celtic House, VenGrowth, TechCapital Partners, and BDC had agreed to invest in the new venture. The terms of the deal were almost unbelievable and reflected the incredible strength of the PixStream team. 'Sign the talent . . . then find the product' was an unorthodox approach to financing even tech start-ups, but the five soon-to-be ex-Cisco managers had so impressed the VCs that they were willing to break with tradition. By the time the dust settled Caputo had succeeded in brokering one of the largest seed-round placements in Canadian history and \$19.5 million was in the bank. Sandvine was founded on August 31, 2001, the day after Cisco closed PixStream.

### Products

As the team was being formed, the founders began the search for products that would provide Sandvine with an opportunity to develop a competitive advantage, and offer a large enough market opportunity to justify the large investment in the company. The group shared a belief in what they thought was an absolute truth: that the Internet would continue to grow and that this reality should frame new product ideas. They also recognized that they had a unique team of software and hardware developers with some very specific skills. With backgrounds that included, in many cases, experience at PixStream, they

This case was written by Detlev Nitsch, David Rose, and Josephine McMurray of Wilfrid Laurier University, Business & Economics, for purposes of classroom discussion.

had the expertise to develop tools that could analyze a thick data stream and determine what to do with its various components. Some other firms could do this too, but what set the Sandvine team apart was their ability to develop products that could perform these functions in real-time, while the traffic was flowing, as opposed to post-hoc analysis done offline. These unique capabilities were the reason it had been so important to keep the team together. After interviewing experts, visiting customers, buying market research, analyzing potential competitors and searching patents for conflicts and undeveloped ideas the team decided that the best opportunities involved products that would improve the profitability of ISPs.

After the product category decision was made, development efforts led to two ready-for-market products in the Sandvine stable:

1. The PPE 8200 Peer-to-Peer Element rearranged peer-to-peer traffic and ensured that each peer-to-peer search was directed down the least costly network path, hence saving ISPs from excessive bandwidth expenses.
2. The Sandvine Subscriber Services Cluster™ provided ISPs with a turnkey solution that would allow them to offer content filtering, virus scanning, and firewall protection to their subscribers.

Both products were designed to be highly scalable so that, from a customer's perspective, keeping pace with growth simply involved adding another unit of the same element to support additional users or bandwidth. All development would be performed in-house, and component manufacturing would be outsourced, with final assembly and testing taking place in Sandvine's Waterloo facility.

### The Internet Service Provider Industry

The ISP industry was vast, and approached perfect competition due to the large number of service providers and ease of access for buyers. ISPs provided access to the Internet in one of two ways. Customers could purchase dial-up service through telephone lines, or they could utilize faster, always-on, broadband technology with either telephone wires or cable. The industry in 2003 was populated by competitors who were distinguishable on many dimensions. Some ISPs were large providers with links to telephone companies (e.g., Bell's Sympatico) or cable firms (e.g., Rogers, COGECO). Others were relatively small local companies that sold Internet access to customers in a small geographic area.

### Value Added Subscriber Services

Many ISPs hoped that providing network-based subscriber services such as Internet firewalls, anti-virus protection, and content filtering, in addition to the basic services, would allow them to create a lucrative monthly revenue stream. Some observers felt that the ISP industry might have the same experience as the telephone market, where competition had been just as intense and where high-margin services such as call waiting, call display, and voice mail had provided a powerful up-sell to kick-start stagnating revenues. These services had continued to be extremely profitable for the telephone service providers, as they had been able to increase prices several times without losing many subscribers. It appeared that customers had little interest in re-evaluating their purchase decision once they had grown accustomed to their new telephone features.

### Peer to Peer

Sandvine knew that it was their P2P traffic management product that would command the initial attention of ISPs and get their foot in the door. P2P file sharing activity was threatening to swamp ISPs in a torrent of off-network traffic. According to some estimates, as much as 65 percent of total Internet bandwidth usage was now devoted to P2P traffic. This was creating a growing and unacceptably large monthly expense for ISPs. When a P2P client connected to other P2P clients on the network, most of the time the client they connected with was outside their ISP's network. ISPs paid companies such as MCI, WorldCom, Sprint, and AT&T a fee every time traffic left their networks, so anything that might reduce these fees would be attractive. The Sandvine solution used a concept of the lowest cost network path by first hunting on the ISP's own network for the requested share and leaving to search the Internet only if the target was not found internally.

### Marketing Strategy

In Caputo's opinion there was a limit to the size of the P2P market. He thought that the subscriber services market was really Sandvine's most attractive opportunity, in terms of both market size and longevity, but would be more difficult to penetrate. Since the subscriber services bundle needed to be installed 'in-line', between the Internet and the user, they were 'mission-critical' products for ISPs. A failure in the Sandvine Subscriber Services Cluster had the potential to shut down an ISP's entire network, which was a risk that Caputo felt ISPs would be unwilling to place under the control of an unproven supplier. Sandvine's P2P element, on the other hand, operated as an adjunct to the ISP's network. A failure would not shut down the ISP's network and thus represented a much lower risk to the ISP's business.

Clearly there was a market, yet Sandvine knew they would have to work closely with their ISP clients to help them educate the end-users. Because of the number of ISPs and Internet users in North America, it seemed clear that Sandvine should concentrate selling efforts initially on that market. However, global development was opening up huge opportunities in Europe and Asia. This led to Sandvine opening a U.K. office in January 2003 and planning an Asian entry later in 2003, to take advantage of first mover status on their technology.

For both the P2P element and the Subscriber Services cluster, ISPs should have a payback period of less than four months.

### The Company

The company had grown very quickly over the past year. There were now 78 employees, organized as follows:

- 43 engineers working on hardware, software, firmware and IT.
- 15 worked primarily on the P2P traffic-management, while 28 were assigned to subscriber services.
- 17 sales and marketing staff in product management, support and business development.
- 12 manufacturing and testing staff.
- 3 people in finance.
- 3 sales representatives in the U.K., Canada, and the United States.

Caputo had deliberately constructed an organization designed to place the customer first, and where there was transparency in

decision-making with little to no political maneuvering. He called his approach the "Sandvine Way" and believed that it would help the company build a distinctive, competitive advantage. Caputo hoped to create an infrastructure that would scale easily as the company grew, without losing the informal, creative, and dynamic spirit that usually characterized start-up technology companies. This intangible was the very first thing that had been lost when Cisco had taken over PixStream. Overnight, effective decision-makers were rendered inoperable as control shifted to the larger entity, with its disparate geographic units and different bureaucracy. Caputo had learned from the Cisco experience that without a common understanding of what was expected of people and what activities were valued, scarce resources would be wasted as the company grew.

Jenn Patterson, the new manager of Human Resources, was a PixStream "grad." Like Caputo, she had been with the company from its birth to its demise and truly understood its distinctive culture. Caputo called on Patterson to work with him to create a simple plan—to begin working on a deliberate culture, a model that would allow the management team to clearly and doggedly communicate their vision of the organization. The "Sandvine Way" was the collective vision of Caputo, Patterson, and other members of the management team and included eight 'truths' that were to be acted on and understood clearly.

Sandvine's five founders remained solidly aligned with their technical mission, but more particularly, having been through the PixStream sale, were aware that there was a point where engineering had to step back to allow the sales and marketing staff to ramp up the company and its products for commercialization.

### Financial

Currently the company had a cash 'burn rate' of approximately \$700,000 per month (estimated at \$100,000 per year per employee in Waterloo and \$150,000 for European employees). The original \$19 million had been augmented with another successful round of financing. To date, marketing expenses remained modest with an emphasis on production of roadmaps, white papers, trade show attendance and PR related to industry analysts. It was estimated that the marketing budget was less than \$200,000 per year, in addition to the payroll expense for employees working in that area.

### Current Situation

Sandvine had just recruited three highly respected sales professionals who were well known in the industry. Each had been given responsibility for one of three regions: Canada, the U.S., and the United Kingdom. Chris Colman had opened the new U.K. office in Basingstoke, Hampshire, in January 2003, as managing director, Sales and Business Development responsible for establishing Sandvine's Europe, Middle East, and Africa (EMEA) division. This was Sandvine's first office outside North America, but they planned to venture into the Asian market with an office in Hong Kong later in 2003.

An inside sales manager helped to direct the overall sales effort, and nurtured and managed a sophisticated Customer Relationship Management (CRM) system. This system allowed Sandvine to input customer information, competitive intelligence, details of competitors, and buyer organization charts in

an effort to scout competitors' activities and bid intelligently on proposals.

At the beginning of July 2003, one P2P customer had converted from 'trial user' to 'buyer.' Explaining the reasons for their purchase, the customer said:

The Sandvine unit integrates easily with our existing infrastructure, and their approach dramatically improves our ability to control the cost impact of P2P on the network. At the same time, it respects our broadband customers' expectations of quality and consistency. Our company's technicians were impressed with the knowledge of the Sandvine engineers and the willingness they showed in fine-tuning the device to optimize performance.

There were a further 15 active trial sites for the P2P elements in Canada and the U.S., in addition to six that were under way in EMEA. There was considerable confidence that all the trials would be successfully converted to sales in the near future. The subscriber services clusters were also on trial. The company was expecting to very shortly announce that two major customers would install their products.

From what Caputo had recently heard from the market, it appeared that smaller competitors in subscriber services were not about to give up without a fight. His assessment of the competitive threat was that Symantec and McAfee were not the only ones he needed to worry about:

Companies that most people likely never heard of, such as F-Secure, Zone, Trend Micro, ZK and others are fighting the gorillas with the only weapon they have . . . price. Customers have told us they have hard quotes for three or more services (such as anti-virus, firewall, parental control, spam elimination, pop-up elimination) for \$1.00. Not per month, but for a year!

The attractiveness of the P2P market was also less than certain. In May 2003, Kazaa Media Desktop had become the world's most downloaded software, having overtaken the previous record-holder, ICQ, by reaching 230,309,616 worldwide downloads. Kazaa was distributed without charge and enabled its users to download more licensed content than any other application.<sup>1</sup> The official story was 'downloading licensed content', but the Internet set wasn't propelling Kazaa, Grokster, Gnutella, and other file sharing software into the record books by downloading copies of MS Office. Kazaa helped users share their favourite music, the latest movies and the hottest new apps.

Around the same time, another media item brought the following news from Apple: *The revolutionary iTunes Music Store puts 200,000 songs at your fingertips. It's built right into iTunes 4 and lets you search or browse genres, new releases, exclusives and more. Preview any song for free. When you find a song you want, buy it for just 99¢. It's what music lovers have been waiting for: a music store with Apple's legendary ease of use, offering a hassle-free way to preview, buy, and download music online quickly and easily for just 99¢ a song. Apple claimed it could make the whole music buying experience easier. Steve Jobs, CEO of Apple, was convinced that the music industry was about to turn a corner in the copyright war. With the government shutting down pirate Web sites and the record industry now going after individuals for alleged*

<sup>1</sup> "Kazaa Media Desktop Sets Most Downloaded Software Record," [www.kazaa.com/us/news/](http://www.kazaa.com/us/news/).

piracy, the Apple chief believed digital theft was becoming more complicated and more risky.

If legal purchases became simple and cheap, Caputo wondered if music fans would overwhelmingly migrate to legitimate services? He found these new developments in the entertainment industry extremely troubling. This was not quite the 'order' that he had expected to emerge in the chaotic and random P2P market. If Apple was just the first of a new breed of legitimate services that sold music affordably, conveniently, and legally, how would this affect Sandvine?

### Conclusion

Despite significant progress since the company's formation, Caputo was worried. Product development had taken longer than expected, and while he was confident that Sandvine would retain its first mover advantage he wondered if the bottom was now falling out of the P2P market. If this occurred, what would be the implications for Sandvine's marketing strategy of using this product as a 'foot in the door' to build credibility and relationships in the industry? And on the subscriber services side,

would ISPs be able to persuade their customers of the value of Internet-based value-added services?

What would Sandvine do if the music industry made music cheap, affordable, and conveniently available through their Web sites? Would ISPs bother with Web-based services without the P2P broadband cost savings? Would consumers buy into the concept of Web-based value-added services? Sandvine's P2P software development had now been stopped and most of the engineering staff was concentrating their efforts on the subscriber services cluster. But any more changes to the strategic plan would have wide-ranging implications for all the functional areas, as well as for the firm's organization structure, staffing, leadership, and culture. For example, how important to the future success of the firm was the "Sandvine Way," and would it be possible to stay true to its key precepts in the face of possible reversals of fortune? "Well", Caputo thought, "I have a week to think about this before the next management meeting. One thing's for sure, though, the next 12 months are going to be an interesting ride!"



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## C · H · A · P · T · E · R

# 10

## THE DEAL: VALUATION, STRUCTURE, AND NEGOTIATION

*When one door closes another door opens; but we so often look so long and so regretfully upon the closed door that we do not see the ones which open for us.*

Alexander Graham Bell

RESULTS EXPECTED

Upon completion of this chapter, you will be able to:

1. Describe methods used by venture capitalists and professional investors to estimate the value of a company.
2. Discuss how and why equity proportions are allocated to investors.
3. Understand how deals are structured, including critical terms, conditions, and covenants.
4. Appreciate key aspects of negotiating and closing deals.
5. Characterize good versus bad deals and identify some of the traps entrepreneurs face in venture financing.

RESULTS EXPECTED

### THE ART AND CRAFT OF VALUATION

The entrepreneur's and private investor's world of finance is very different from the corporate finance arena where public companies jostle and compete in well-established capital markets. The private company and private capital world of entrepreneurial finance is more volatile, more imperfect, and less accessible than corporate capital markets. The sources of capital are very different. The companies are much younger, more dynamic, and the environment more rapidly changing and uncertain. The consequences, for entrepreneurs and investors alike, of this markedly different context are profound. Cash flow is king, and beta coefficients and elegant corporate financial theories are irrelevant. Also, liquidity and timing are everything, and there are innumerable, unavoidable conflicts between users and suppliers of capital. Finally, the determination of a company's value is elusive and more art than science.