Venture capital

For businesses requiring additional finance, which are unable to increase their level of borrowing, venture capital (also known as private equity finance) might be the answer.

Venture capital firms provide financing in return for a proportion of your shares. They take a higher risk than banks in the expectation of receiving higher returns. For your part, you have to decide whether the involvement of a venture capital firm is worth a smaller slice of a larger pie.

This briefing outlines:

- Whether venture capital will suit you.
- How you can obtain it.

1 A suitable case

Your business is most likely to be suitable for a venture capital investment if:

1.1 You want a **minimum** investment of £250,000.

- Smaller amounts may be available in special cases, but is often easier to raise £5m than it is to raise £500,000.

1.2 You can offer the investors the possibility of a **high return**:

- This usually means a compound return of at least 20 to 30 per cent per annum on their investment. Most of this return will be realised as capital growth.

1.3 You have a balanced, experienced and professional **management team**.

- Your management team needs to have a successful track record.
- You need to show commitment.
  In practice, venture capital firms usually measure this in terms of personal investment. They are likely to want a significant part of management's personal earnings to be strongly linked to business performance.
- All key personnel must be contractually tied in on mutually agreed terms.
  For example, an advertising agency will find it difficult to secure venture capital if key creative people could leave.

1.4 Existing businesses should have a successful **track record**. The venture capital firm must be sure your business will generate sustainable and predictable cashflow and profits in the near term if not already profitable.

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- Most venture capital firms provide expansion financing.
  This allows an already successful company to achieve the next stage in growth by, for example, increasing capacity to meet demand or developing new products.
- Finance is often provided for management buy-outs (MBOs) and management buy-ins (MBIs). An MBO allows an existing business to be acquired by its current management team. With an MBI, an external management team buys in.
- Some exceptionally promising start-ups can attract venture capital to finance their development and marketing costs.

1.5 You are able to provide an **exit**. Most venture capital firms will want to realise their profits, typically within three to seven years.

The most common exits are:

- A trade sale to another company.
- Refinancing of their investment by another institution.
- A listing of the shares on an exchange, such as PLUS (previously known as OFEX), AIM or the Stock Exchange Main Market.
- Repurchase of the venture capital firm's shares by management.
  Even if the venture capital firm is not going to exit, it will want to keep this option open

2 The drawbacks

2.1 Venture capital imposes certain **constraints**

- You will have to generate the cash needed to make the agreed payments of capital, interest and dividends (see **3**).
- Specific legally binding covenants will be included in the investment agreement to protect the venture capital firm.

  For example, you may have to agree to limit the amount you are paid or to be prohibited from involvement with other companies with conflicting interests. You may be required to obtain the venture capital firm's approval before making certain major decisions.

- The venture capital firm may require a nominated representative on your board, typically as a non-executive director.
  This director may want to provide hands-on management if things are going wrong but will usually only be involved in strategic decisions.
- The venture capital firm will expect regular information and consultation to check how things are progressing.
  For example, monthly management accounts and minutes of board meetings.

2.2 Acquiring venture capital involves considerable **expense**.

Total costs of ten per cent or more of the amount raised are not uncommon for smaller investments, and five per cent for larger amounts.

- You will need professional advice (see **6**).
- You will usually be required to pay the venture capital firm's costs.

2.3 Acquiring venture capital involves considerable **management time**.

The whole process typically takes three to six months, though it can be much faster.

- It is not unusual for business performance to decline during this time as management is distracted. This should be addressed.

2.4 Investment deals can **fail** at the last moment. The most common reasons are:

- Failure to agree a price or other key terms.
  This is especially common when several investment firms join together (syndicate) to provide the necessary finance.
- Legal problems cannot be resolved.
- Trading performance declines substantially during the process of raising investment.

3 Types of finance

3.1 **Ordinary shares** give the venture capital firm ownership of an agreed proportion of the company. The venture capital firm's return is made up of a combination of any dividends and the increase in the capital value of the shares.

- Ordinary shares are cheap for the company to finance in the short term.
  Dividends can be zero (unless the investment agreement specifies otherwise) but may be a contractual share of profits.
- Negotiations over the proportion of shareholding that the venture capital firm receives for an investment can be long and difficult.
  You will tend to value your company, and thus your shares, more highly than outsiders will.

3.2 **Preference shares** are similar to debt, as they pay a fixed dividend and are repaid on specified dates. But they are unsecured.

➨ For investments of less than £250,000, you usually need to approach business angels.
A notable exception is the HSBC Enterprise Fund, which makes venture capital investments between £10,000 and £250,000.

- Unlike debt, preference shares protect you against having to pay out cash while the company is making losses (for example, while you are entering a new market).
  You are prohibited by law from redeeming (repaying) preference shares or paying dividends on them unless the company has generated sufficient profits (distributable reserves) to do so.

3.3 Debt consists of overdrafts, loans, hire purchase, leasing and other borrowings.

- Debt is usually secured against specific assets (eg your premises or debtors).
  If the company is unable to pay the capital repayments or the interest on time, the lender can sell those assets. This may cause the company to cease trading.
- Usually you borrow from a bank, rather than from a venture capital firm. But some firms can provide loans, leasing and hire purchase as well as equity finance.

4 Approaching investors

4.1 Determine **how much** finance you need to raise and what your timescales are.

- How much other capital do you have access to?
- Could you raise finance by other means? For example, by selling and then leasing back property or other assets.
- What level of capital and interest payments (and preference share dividends) can your cashflow support?

4.2 Prepare a professional **business plan**.

This needs to convince potential investors that your business has good prospects and that you know what you are doing.

- Involve an accountant or other professional adviser (see **6**).
- You must have evidence to support your financial projections. This includes details of your assumptions and how sensitive your projections are.

4.3 Identify **potential investors**.

- Your accountant or corporate finance adviser may know suitable firms.
- The British Private Equity and Venture Capital Association (BVCA) (www.bvca.co.uk) publishes a directory of members and a guide to raising venture capital. The directory lists each member's preferred investment amounts and industries.

4.4 Contact selected venture capital firms

- It is most productive — but not essential — to approach venture capital firms through a professional adviser who has previously worked with them.
- Prepare a concise executive summary of your business plan — typically no more than six pages — to circulate to them.
- Confirm that they have some interest.
  Do they make investments of the amount you seek in your type of business?
- Send them your business plan and arrange an initial meeting.
  Prepare a concise, persuasive presentation.

  You will be in a stronger negotiating position if you can interest more than one venture capital firm in investing in your business.

Getting a thumbs down

Venture capitalists say there are six reasons for turning down an approach without even meeting a company:

- The company is looking for too small an amount.
- The management does not have a strong enough track record.
- The business plan is unprofessional.
- The company's profit forecasts have been 'plucked out of the air.
- The company is in an industry they do not invest in.'
- They have already invested as much as they want to in that type of business.

5 The investment process

Once a venture capital firm becomes interested, negotiations can be long and stressful. Your professional advisers can help you.

5.1 Use the **initial negotiation** to get an indication of how much venture capitalists are prepared to invest, and what they will expect in return.

At this stage, everything they say will be subject to further negotiation and due diligence (see **5.3)**.

Try to confirm that the investment terms are likely to be acceptable to you. For example:

- Roughly what percentage of the company will they expect to own in return for their investment?
- What requirements the investor may want to impose as an integral part of the deal?

- Will they want to supply finance in a lump sum or in stages, increasing investment as the company reaches specific targets?

5.2 Negotiate which of the venture capital firm's **costs** you will have to pay.

- These include their professional costs for due diligence (see **5.3)**.
- All their costs should only be payable in the event the investment is completed.

5.3 Make the lengthy **due diligence** process (typically one to three months) easier by preparing as much information as possible and arranging easy access to records.

The venture capital firm's advisers will carry out due diligence to confirm the key details of your business. In particular:

- Financial details. For example, the real value of your assets and liabilities; how realistic your profit and loss forecasts are; how good your financial controls are.
- Legal details. For example, whether the business is involved in any litigation; what the key supplier and employee contracts are; whether the business has clear title to its properties and any intellectual property.
- Key business factors. For example, what the business trends are; how well the business is managed.

Ensure that everybody connected with the due diligence process has been thoroughly briefed on the project. The venture capital firm may seek to renegotiate if negative factors have been revealed by the due diligence process.

5.4 Use a solicitor to help draw up and negotiate the main terms of the **investment agreement** which may include:

- The terms of the investment, such as how much finance will be provided, in what form and what rights investors will have.
- Warranties confirming that information which you have provided is true. If the business later fails and it is proved that you gave misleading information, the investor will usually have the right to claim compensation from whoever provided the warranties (typically you).
- Indemnities, where you agree to accept liability in certain circumstances. For example, if the company is sued in regard to pre-existing contracts.
- Service contracts that tie in key members of management and staff.

5.5 Nothing will be finalised until the agreement is **signed**. In particular, the final terms may not be negotiated until the last minute when you are desperate to complete the deal.

6 Using advisers

6.1 Select advisers who are **specialists**. Request — subject to confidentiality — a list of the venture capital deals which they have personally completed in the last 12 months.

- Your existing firm of accountants may have a partner who is a genuine corporate finance specialist.
  (Corporate finance includes both buying and selling companies and raising finance for them.)
- Otherwise, you can use an independent corporate finance specialist to work alongside your existing accountants.
  Ask existing business contacts and advisers for recommendations. Confirm what the specialist's areas of expertise are.

6.2 Use your **accountant** (and corporate finance specialist) to:

- Appraise your project and advise whether you should proceed.
- Help draft a business plan.
- Introduce you to suitable venture capital firms and help you with the presentation.
- Help with the financial side of the due diligence process.
- Help negotiate valuations and costs.
- Advise on the financial structuring of the deal and tax implications.
- Help close the deal.

6.3 Use your **solicitor** to help you with the legal side of due diligence and other legal aspects of the deal.

- These might include service contracts for key employees and conflicts of interest in the case of management buy-outs.

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