EVALUATING A VENTURE CAPITAL FIRM TO MEET YOUR COMPANY'S NEEDS

What is the best way to approach and work with a venture capital firm? What do venture firms look for in evaluating a new company? How should the entrepreneur go about evaluating that firm and any financing it might provide his company?

Venture firms are as different as entrepreneurs. There is thus a wide range among these firms in terms of their industry expertise, business experience and, most importantly, their ability to work effectively with you.

Your process of selecting a venture firm is, therefore, much more analogous to the selection of key managers in your company than it is to the selection of a bank for a loan. With a banker, the appropriate question is "How much money will he give me?" With a venture firm, the right question is "How much money will he make me?"

This is because your venture firm, if used effectively, will be an important element in the continuous decision making process of your company. The venture capitalist can bring a broad perspective of experience to your corporate problems based on multiple other corporate situations in your industry with which he has been involved. This experience enables him to recognize patterns within your company and industry niche which may be invisible to you. For example, he would be aware of external factors beyond your control which are already influencing other market niches in your industry and which your company will either capitalize on or be limited by.

When you select a venture firm, you are likely to be embarking on a relationship that will last five to ten years or more and which can be a pivotal factor in turning your company into a major enterprise. Because of the rate at which a high growth venture company encounters new challenges, decision making times can be greatly shortened. Therefore, the relationship with your venture firm can be critical.

A talented venture firm reinforces management's naturally good instincts on solving corporate problems and discerning industry directions. The less experience you have in some matters, the more you may need to rely on your venture firm's advice. The more experience you have, the more you will appreciate the quality of the advice.

The venture firm's investment makes it uniquely dedicated to your success. Venture firms only "succeed" if you succeed and this frequently depends on their ability to persuade you to do what is in your own self-interest.

Therefore, the key question to ask in evaluating a venture firm is: do you believe that you can develop a relationship with the firm such that your confidence in it will accelerate your problem solving and decision making to enable you to emerge as a world class competitor in your industry?

HOW VENTURE FIRMS EVALUATE YOU

This is a two way process: you should be evaluating venture firms and how well they understand your market at the same time they are evaluating you. Unless you have previously known and worked with a venture firm, you should expect to have a number of intensive meetings with the firm's principals to develop a personal relationship.

Remember, the venture firm is backing you and your team as individuals. A new start-up is like a marriage - both parties must get to know one another well before any long term plans can be made.

THE BUSINESS PLAN

The business plan you present to a venture capital firm will likely be the single most important written document in the early years of your firm. Investigation of this plan by the venture firm will account for much of the discussion you have with the venture firm. It is the vehicle around which you get to know each other.

The plan should contain the business concept, the marketing, production and technology elements, the backgrounds of the principal founders and how much money will be required. The more specific the plan, the better - both for the venture capitalist now and you later on. Ironically, experience has shown that the longer the plan, the lower the likelihood of success. The concise articulation of a simple but powerful concept for an innovative solution to an emerging but important unmet customer need is the hallmark of a good business plan.

As every business has different needs and goals, one really cannot be much more specific about what should be included in a plan. However, there are some general principles that can be followed, both in developing the plan and in thesubsequent dealings with the venture firm. You can keep these principles in mind and assess your own plans and discussions against them.

DEFINING YOUR CONTRIBUTION

It may seem self-evident to say that a new company must make a true contribution to prosper, but attention to this fundamental discipline of a free market system is often lost in the enthusiasm to start a new company in a growth market. Unfortunately, despite that growth, market share will only go to a new company if it is adding value by solving unmet customer needs.

A simple formula venture capitalists tend to use in evaluating the potential size of your company is:

Market Size x Market Growth x Your Contribution = Size

Naturally, the more experienced the venture capitalist is in your industry, the more readily he is likely to grasp the significance of your contribution to the target customers.

In defining your company's contribution, a balance must be struck between biting off too much too soon and not having adequate "value-added" to justify starting the company. If the definition of "served customer needs" is too narrow, the company will tend to be vulnerable, small and potentially trapped in a limited growth path. On the other hand, too broad a definition requires resources beyond what the company will have for years.

Ideally, a company should initially serve highly specific customer needs that lie within a broader generic category of needs of the same customers or industry. The company can then execute profitably in the short-term as well as grow smoothly through a coherent product line and market expansion. To grow continuously, a company must constantly and more broadly redefine its contribution to the market. Last years' contribution must become next year's "feature" within a broader definition.

INDEPENDENT VERIFICATION OF KEY PLAN ASSUMPTIONS

Every business plan rests on certain key assumptions. These often include the technological expertise of the founders, production techniques and marketing strategies.

The analytical role of the venture firm is to identify these key assumptions and then independently correlate them with both independent sources of information and the venture firm's own experience. Time can easily be wasted performing due diligence on irrelevancies.

You can help this process, and thus speed up decision making, by clearly stating key assumptions on which your new firm's success will be based and identifying independent sources - customers, former employers, or industry experts - for verification. Of course, the more knowledgeable a venture firm is in your industry, the easier it will be for them to recognize the key assumptions and independently verify them with their own sources.

RISK IDENTIFICATION

Venture firms approach the venture business as much from the standpoint of "risk reduction" as from opportunity maximization. That is, the operating assumption is that opportunities can be realized by eliminating the risks (impediments) to their achievement.

Almost by definition, the companies in which venture firms invest will be standing in the middle of enormous opportunities. The practical problem then becomes how to eliminate the impediments to achieve this success.

Thus, your plan and your discussions with the venture firm must address the question of risk reduction: how much money will it take to eliminate each major risk, and what will be the milestones in measuring whether that goal is being achieved?

Obviously, risk can never be fully eliminated; however, there are definite benchmarks in technical and marketing accomplishments that represent the lowering of risk levels.

Performing an analysis with respect to risk reduction will put you on the same wavelength as your potential venture investors. You can evaluate in this process whether the venture firm really appreciates the risks particular to your industry. Of course, each milestone of risk reduction achieved is the basis for raising additional money for the company.

COMPETITIVE ANALYSIS

The absence of good analysis and lack of and appreciation for the competition are probably the most common mistakes made by new entrepreneurs. Therefore, one way to distinguish yourself and your business plan from the many others a venture firm is reviewing is through the quality and completeness of your analysis of the competition.

If you have done such an analysis, you will be able to easily convince the venture firm that your key assumptions are realistic and reasonable. Furthermore, in the process of describing the competition, you will accelerate the education of the venture firm vis-à-vis your relative position in the market. You will find that this "relative" information is very important to the venture firm in reaching a decision.

Insightful understanding of the competition in your marketplace by the venture firm can be critical to obtaining their initial backing. Usually, new technology driven markets emerge at the intersection of two or more established markets. A subtle grasp of why the traditional suppliers will be slow to cross into this emerging product market category is critical to comprehending the opportunity for a new company. Of course, when it comes to assisting in future product strategy and money raising, this competitive understanding by your venture firm is critical.

OPENNESS

Entrepreneurs often worry that venture firms will be frightened off if they know how many risks are really involved in accomplishing the business plan of a new venture. This can be a fatal mistake for the entrepreneur, because an experienced venture capitalist is not likely to make a positive decision until these questions have been answered.

Your objective, assuming you want to do business with a particular venture firm, is to get the venture capitalist comfortable with the project and management team. The venture firm must not be made to feel there are "unknowns" lurking in the background yet to be discovered.

In your first meetings with a venture capitalist, it may appear that his limited knowledge about your particular industry niche makes it unnecessary or unwise to tell him all the problems that your company will face. This is a serious error to make.

When a venture capitalist doesn't know what the right questions are, he won't make a positive decision. Rather, he will just keep asking questions until he feels he has asked the right ones. Since your objective is to get the venture capitalist to make a quick, positive decision, you may as well identify what all the problems are up front.

Remember: a venture firm is in the business of working with the problems you foresee in your company's growth, so you need not be concerned that identifying these will frighten off the firm. Dealing with risks and uncertainties is a venture capitalist's business, and you need to get him quickly to the point of feeling he knows what those uncertainties are.

Most venture firms also realize that every management team will initially have significant gaps in its experience. Often the team has the technical expertise necessary to build the product but only limited marketing and general management experience. Actually, this can be a positive and low-cost approach to getting started.

The best way to protect against easily frightened - or worse, less-than-capable - venture capitalists is to be open about the problems. If they are frightened off, don't regret it. When a venture capitalist only wants to hear about the opportunities and not the problems, then *you* should be nervous.

OBJECTIVE STANDARDS

Evaluate a venture capital firm the same way you would evaluate any key management team member. That is, look at the firm's record of experience, external contacts and accomplishments. How directly relevant to your company's challenges is this record? Has the firm done it before? If you don't feel comfortable with first hand impressions, check with other entrepreneurs with whom the firm has worked. Some specific areas about which you might inquire include:

- What companies has the firm been involved with in the past, and how does the history of those companies compare with the future you envision for your company?
- What was the firm's relationship with those companies? Was it as a passive investor, or did it make a constructive contribution?
- What do the entrepreneurs in those companies say about the firm's contribution?
- What industries is the firm investing in? Does the firm have sufficient experience in your industry to understand and contribute to your potential?
- How helpful is the firm going to be in the future financing of the company? What has it done for other companies along this line in the past? Has it stuck by its companies in difficult times?
- Does it have a reputation that will attract other financial sources? Does it know how to handle investment banks and other financial sources to minimize the future dilution?
- What is the depth of resources of the firm in terms of people and money? You should get to know as many as possible of the principals and consultants of any firm since they all represent potential resources available to you in the future.
- Will the firm be helpful in establishing overseas sales and distribution for you? For technology companies, overseas sales can be key to a company's financial success
- Will the firm be helpful in finding and attracting key managers when needed by your company? Do the firm's historical associations suggest: access to high quality technology managers in your industry, a reputation that will help attract them to an embryonic company, and experience in evaluating such managers?

The answers to these questions will be infinitely more important to the eventual value of your company than the terms or amount of your initial financing. Indeed, while every entrepreneur's first objective must be to get a good price for his company, a common mistake among first time entrepreneurs is to be overly concerned with this goal.

Excessive preoccupation with achieving the "best deal" can result in a delayed project or, worse, becoming "over shopped" to the point of not being able to be financed. In practice, the price will not vary much from firm to firm - after all, venture financings are a free and competitive market. No venture firm will remain in business long if its pricing is not essentially competitive and fair.

New companies should add to their management team the highest quality people who can be found. Never compromise in favor of someone who can be added for a little less salary or equity. The higher the quality of the individuals, the more likely they are to make key contributions. The same advice holds in evaluating and selecting a venture firm: aim for the very best.