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# Entrepreneurs and Venture Capitalists

## 1.1 INTRODUCTION

From early beginnings in the aftermath of World War II, and rapid expansion from the mid 1970s, the venture capital (VC) industry has evolved from an ad hoc collection of pioneering investors into a sophisticated, fast paced and highly specialised industry. During this period, venture capitalists (VCs) have provided the fuel for entrepreneurs to create a generation of companies that have changed the face of the planet. The exponential growth (and occasional dramatic decline) of the computing, communications, biotechnology and internet sectors has placed the VC industry firmly in the limelight, and subsequently under the spotlight, as volatile capital markets have taken their toll.

The question of how the VC industry works, however, remains a mystery for many novice entrepreneurs, and the dynamics of VC deals are challenging for those without first-hand experience. This book examines the fundamentals that drive the VC industry, explains how these fundamentals translate into investments, and culminates in a blow-by-blow account of how venture capital deals are structured.

Understanding the relationship between "entrepreneurs" and "venture capitalists" is at the very heart of this book, and is the key to structuring a win-win deal that creates value for both. The first step in beginning to understand this relationship is to take a look at exactly what entrepreneurs and VCs do, to examine what kind of people they are, and to establish why they need each other.

## 1.2 ENTREPRENEURS AND BUSINESS CREATION

Understanding what VCs do is best tackled by first considering the focal point of the industry – entrepreneurs who create businesses worth backing. Entrepreneurs have been creating opportunities, pursuing ideas, and starting businesses of one form or another since the dawn of time. But the precise question of what an entrepreneur *is*, what an entrepreneur *does*, and what characteristics he or she should ideally possess is something that has taxed economists and philosophers alike for the last 250 years. These may at first seem like obvious questions to answer, but the problem is the following: We all know a successful entrepreneur when we see one; we all have our own ideas about what they are like, but if you try to describe the characteristics that "make" an entrepreneur successful, it suddenly becomes very difficult. Successful entrepreneurs display a huge range of attributes – most of which apply to successful people in just about any walk of life. Copious amounts of research at business schools around the world have failed to develop reliable psychometric tests or even define specific personality profiles that predict who is likely to be a successful entrepreneur. The reality is that entrepreneurs come in all shapes and sizes, and from a variety of educational backgrounds, meaning that the task of picking the likely successes from a crowd of hopeful entrepreneurs is, by definition, extremely difficult. This, however, is the challenge faced by VCs on a daily basis as they witness a succession of hopeful entrepreneurs presenting their

business ideas with the aim of securing much needed investment. For VCs the difficulty of trying to select management teams and business ideas they believe will evolve into successful high growth businesses means that in general they "hope for success but plan for failure" when they make investments. The resultant investment agreements between VCs and the entrepreneurs they back are structured to reflect this sentiment and, as we shall see later in the book, many of the deal terms are designed to minimise the VCs exposure in the event of financial failure of the entrepreneurial venture.

**Text Box 1.1: The Evolution of Entrepreneurs**

The word "*Entrepreneur*" was first used in an economic context by the French philosopher Richard Cantillon in 1755. Cantillon's original definition of an entrepreneur was a simple trader, with an eye for opportunistic profit. Cantillon's entrepreneur "bought at a certain price and sold at an uncertain price, thereby operating at risk". Cantillon's entrepreneur was, by definition, an individual who specialised in taking on risk and lived on his wits.

The economic definition of an entrepreneur was modified a few years later by another French economist, Jean Baptiste Say. Say was the first recognised Professor of Economics in Europe and also ran his own business. His vision of the entrepreneur was of a more sophisticated individual able to identify an important market need and marshal the resources, including manpower, raw materials and the finance required to meet that need.

The economist Joseph Schumpeter advanced the concept of the entrepreneur yet further in the 1930s and 40s. Schumpeter stated that entrepreneurs were innovators and change agents who brought about "a gale of creative destruction". They change the way we perceive the world, live our lives and do business.

But is entrepreneurship all about the person or is it simply a process? This question is addressed in the definition of entrepreneurship put forward by Professor Howard Stevenson of Harvard Business School as "the pursuit of opportunity regardless of resources currently controlled". This definition captures very nicely the image of entrepreneurs being driven by the pursuit of opportunity and being able to muster the resources to do so on a flexible ongoing basis – perhaps using their networks to get things done when they don't actually own the resources to pursue opportunities on their own.

It is the last two definitions of entrepreneurship on which the VC industry focuses its attention. The personal computing, software and biotechnology sectors are prime examples of industries built via entrepreneurs who innovate, create and change the world. VCs look for businesses with the potential for global impact and they back entrepreneurs with just such a vision. VCs also appreciate that although a great deal of successful entrepreneurship is about having the right people, it is also a process in which businesses are built via the aggressive pursuit of opportunity, and in which their role is to provide the financial resources as the business grows.

## 1.3 WHY ENTREPRENEURS NEED EXTERNAL CAPITAL

A good starting point in any discussion of venture capital is to ask the question "why do entrepreneurs need to raise finance at all?". It probably sounds like there is an obvious answer too, but why don't all new ventures start up on a shoestring (i.e. with minimum finance) and simply grow as the cash flow generated from sales allows? Many successful businesses have been built this way and it is a formula that has worked for many types of start

up. Indeed, Professor Ian MacMillan of Wharton Business School summed up this key virtue of many a successful entrepreneur with the following “Miser’s Axiom”.

**Text Box 1.2: The Miser’s Axiom**

*Never buy new what can be bought second-hand*

*Never buy what can be rented*

*Never rent what can be borrowed*

*Never borrow what can be begged*

*Never beg what can be salvaged*

This attitude to venture creation is at the core of what entrepreneurial management teams often do best – they manage very limited resources. They beg, borrow and salvage in order to propel a new venture as far as possible because they rarely have the resources to make it work.

The reality is, however, that most new ventures need a cash injection at some stage and many will require large amounts of cash before they generate revenue. In the biotechnology industry for example, it may take $100 M of investment before a company even gets close to launching a product. Other business models may require substantial early-stage funding in order to rapidly create and embed a viable market position for long-term return on investment and competitive positioning, which could not be achieved through cautious, organic growth.

External finance is needed, therefore, when the business is aiming to grow faster than cash flow generated internally will allow. External finance simply bridges the cash flow gap between the start up phase of a new venture and the point at which that new venture becomes self-sustaining via internal cash flows that are sufficient to maintain its optimum growth profile. This is the fundamental, and very simple reason that entrepreneurs need VCs. VCs will bridge the gap when, usually, no-one else will.

All new ventures undertake a journey from the “Valley of Death” to the “Promised Land”. In other words the bank balance of a new venture declines to the point at which cash flow in

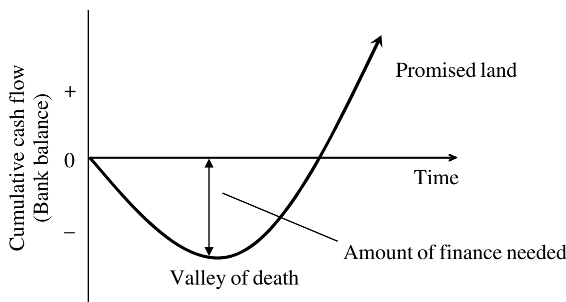


Figure adapted by kind permission of Prof. Sue Birley and Prof. David Norburn (*Mastering Entrepreneurship*) ed. Sue Birley and Daniel F. Muzyka, p. 159.

**Figure 1.1** The Valley of Death

is equal to cash flow out. That turning point indicates the maximum negative amount the bank balance of the new venture will reach and hence the total amount of cash needed to "reach the Promised Land".

Many start ups fail not because the business proposition was fundamentally poor, but because the cash flow management just did not work out – in other words the business ran out of cash just before securing the first customer, or raising the next round of finance. Raising enough cash to cross the Valley of Death (with a little spare) is, therefore, the priority for most entrepreneurs and an enormous amount of time and effort is devoted to courting the VCs who possess financial resources to fuel this journey.

## 1.4 VENTURE CAPITALISTS

The modern VC industry is highly sophisticated and notoriously difficult to understand, but it's really very simple. VCs are aiming for one thing: capital gains. VCs are professional fund managers who invest cash in high risk start-ups, in return for equity (i.e. shares), with the aim of generating very substantial capital gains by selling those shares at a later date through some form of exit event, such as a trade sale or trading the shares on the stock market after an initial public offering (IPO). The golden rule of investment "buy low, sell high" is modified in the realm of venture capital to "buy *very* low sell *very* high" to account for the extreme risk profile of such businesses and, as we shall see later in this book, VCs employ a wide range of legal and financial instruments to manage the extreme investment risks they are taking.

Most novice entrepreneurs who deal with VCs, however, don't think of them as being in a business subjected to the same responsibilities and pressures that all businesses have – in other words providing a return to shareholders (as we shall see in Chapter 2, the "shareholders" for VCs are the so-called limited partners who provide the VC with funds to invest). Rather they think of them as a kind of giant cheque-book providing an endless supply of cash that must be coaxed across into the hands of the entrepreneur on the best terms possible; the entrepreneur must first stalk an unsuspecting VC, wrestle him or her to the ground, force a pen between their fingers, prise open the cheque-book and get them to sign. More experienced entrepreneurs take a different view – they regard a VC not just as a walking cheque-book, but also as a giant Rolodex, offering the potential to broaden their networking range, to open influential doors and ultimately to accelerate business growth. In the true spirit of "beg, borrow and salvage", VCs are not just a source of finance for entrepreneurs, they are business partners who can be drawn upon to provide advice, an email account, office space, meeting rooms and above all, the credibility that investment from a top quality VC bestows upon an otherwise unknown start up business.

These preconceptions are of course partly based in truth: from the entrepreneur's perspective the most mis-used word in the VC lexicon is probably "value-added" (as in "we are a value-added investor"), closely followed by "smart-money". Precisely how much value VCs bring to the business beyond the cash they invest has been the subject of extensive research and in some cases the jury is still out. The research has concluded that VCs add lots of value in some areas, less value in others and in some areas can even destroy value! While it is undoubtedly true that top quality VC firms can deliver significant added value to a business from time to time, it is overwhelmingly the case that the single most valuable service provided by VCs to the entrepreneurs they back is the investment of cold, hard cash. But for an entrepreneur to view this act in isolation is a grave error, which may indeed scupper

the entrepreneur's hopes of successfully securing venture funding on attractive terms in the first place.

Although it is probably sound advice for entrepreneurs to assume that a VC will add negligible value to the venture beyond the act of funding it, it is equally true that unless they understand the nature and dynamics of the VC's business – essentially the context within which the interaction will take place – they will be unable to grasp the factors and resources that underpin the fundamentals of VC investing and will therefore be unable to turn these factors to their advantage. In such circumstances, either entrepreneurs will inadvertently present the investment opportunity to the VC in a way that leaves the VC unmoved, or (often worse) will secure investment from the VC on highly unattractive terms and embark on a deeply flawed relationship with their new "business partner" (after all the VC fund is now a part of owner of the business) in which they will not be able to leverage the relationship to its maximum potential. Even worse, by accepting a bad deal from a VC the seeds of eventual business failure may already have been sown for the fledgling business venture.

Therefore, before examining how to access a VC or differentiate between them, it is essential that an entrepreneur takes some time to understand the nature of the beast – the dynamics of the business model employed by most VCs, the marketplace in which they seek to compete, and the core business philosophies and mindsets that derive from these factors and which will dramatically influence the interaction of VC and entrepreneur.

VC investment in the early twenty-first century is undoubtedly a business, as opposed to philanthropy. It may as yet remain a "cottage industry" in many parts of the world, with question-marks regarding the ability of the sector to scale or leverage its traditional business model beyond small partnerships, but it is nonetheless an industry operating in an intensely competitive environment. As such, every VC firm will, to a greater or lesser extent, experience the same business and operational issues, the same market pressures and the same strategic constraints and these will in turn each drive the behaviour of every VC down very similar paths. As such, VC firms are no different from any other business operating in a mature and highly competitive industrial sector – and in many ways they are no different to the entrepreneurial ventures they back.

If the entrepreneur can come to understand these key dynamics of the VC's business, the tools of the VC trade and the way in which a VC strives to use them to manage risk, as well as the established business environment and process within the industry, then that entrepreneur will be best-placed to address two key issues: First, whether VC finance makes sense in the context of their own personal and business ambitions: and second, to obtain the best deal possible and structure a productive relationship which extracts maximum leverage from what the VC has to offer post-deal. When this is achieved, the chances of commercial success for the venture will often be dramatically improved.

## 1.5 HOW TO READ THIS BOOK

This book was inspired by the many entrepreneurs who struggle to understand the business of venture capital when they first encounter it. Although at first glance it may seem that entrepreneurs who understand VC deals must be a bad thing for VCs (aiming as they do to get the best deal) this is not the case. For a VC, doing business with an entrepreneur who does not understand the constraints and pressures of the VC model – and who accordingly does not understand the process he or she is entering or the legitimacy or otherwise of the key clauses in an investment contract – can be a long, uphill and often unproductive battle. By contrast,

the engagement between a VC firm and an entrepreneur who knows the landscape he or she is entering and where and how an investment proposal may be flexed, is like a breath of fresh air for the VC firm and will mean that BOTH parties can set about reaching a fair, flexible and creative agreement in a calm and business-like manner. Deals are completed quicker, relationships are preserved and businesses are built faster when each side of the negotiating table understands what makes the other tick. This is the aim of the book.

Part I explores the business of venture capital, examining how the fundamental dynamics of the business drive the day to day behaviour of a VC, and concludes by examining the key criteria that a business must have in order to position itself optimally within the VC's own business environment – in other words, to be positioned attractively for VC investment.

Part II of the book examines in detail the process of raising venture capital finance, including a look inside the decision-making process for most VCs, how VCs value businesses, and how to get through the door for that crucial first meeting.

Part III of the book drills into the fine detail of what a venture capital investment proposal or "term sheet" looks like. We have included an example pro forma term sheet in Part III – which is derived from the industry standard or "boiler plate" term sheets that are now used across many jurisdictions including the USA, Europe and Asia. We have unpicked each clause in that term sheet so that entrepreneurs (or indeed VCs) engaged in negotiations can understand what the clause means, why it is there and how it may be flexed. Part III of the book need not be read "sequentially" and can be used as a reference source for addressing any aspect of a VC investment transaction at any time.

We hope that by the end of this book, entrepreneurs, VCs, investment banking professionals, corporate lawyers and MBA students engaged in the art of entrepreneurship will have a very clear handle on the nature of the entrepreneur-VC relationship, and more importantly, how to make it work.