What Founding Teams Should Understand About Raising the First Round of Venture Capital

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For many first time entrepreneurs, raising venture capital can seem like a formidable and arcane task. The objective of this article is to shed light on the process and increase the probability of a successful fundraising effort.

THE STARTUP SEEKING VENTURE CAPITAL

Before beginning to raise a first round investment from venture capital funds, the founding team will need to write a business plan. The plan should describe what product will be developed, and why there is a market need for the product. The plan also should delineate the milestones which will be achieved, and how much capital will be required at each phase of development.

The founding team should use their network of lawyers, accountants and entrepreneurs to help identify which venture funds are most likely to invest. Variables to consider when targeting venture funds include the industry in which the company will operate, the amount of capital required and the stage at which the fund prefers to invest. Founders should ascertain that the funds they approach have not invested in companies which might have conflicts with the startup, either because of market focus or the nature of the products being developed.

Historically, startups were safe if they approached a sufficient number of firms to raise two times to three times the amount of capital required. Today it's worth approaching an even larger number of funds. Investors are more cautious, and some have depleted their capital.

A founder can call and introduce himself to the individual in the partnership to whom the startup has been referred. It will be helpful if the person who referred the company to the fund has already contacted this individual, so the call will not be unexpected. Blind submissions to most venture capital funds are not given strong consideration.

Assuming the founding team is invited to present to the partnership, founders will need a presentation that follows their business plan.

It will be valuable to the founding team to know the kind of information the fund will need in order to decide whether or not to invest. Founders should be prepared to provide the following:

- Projected size of market, and validation that prospects have a need for the product
- Description of the product to be developed
- Time and cost to develop the product
- Regulatory path and expected reimbursement amount for biopharmaceutical and medical products
- Strength of patent coverage

- Amount of capital required before the company reaches cash-flow break even
- Resumes of the members of the founding team, along with a list of references
- An estimate of the value of the company at exit/realization, and thoughts on when this might occur

The founding team should have some range of pre-financing valuations that they will accept. Founders can uncover the valuations of "similar" companies from law firms, other entrepreneurs, and online data bases such as "Venture Source" from Dow Jones. Sometime during the evaluation process, the founders should let the prospective investors know what valuation is acceptable. If the low end value is too high for the fund, it is in everyone's interest to know this early so time and effort are not wasted. The fund should tell startup management teams what returns they expect to earn from their investments, either as a multiple of capital or a rate of return.

It will be useful for the founders to know if a potential investor is a lead investor or a follower. Lead investors prepare a term sheet, strive to reach agreement on terms with founding teams, and will recruit a syndicate to invest the needed amount. Followers are passive, but may join a syndicate.

It's valuable to ask each fund when they closed the fund from which they are currently investing. If the answer is greater than 3 years ago, the fund may be low on capital. Ascertain that the fund has the capacity to reserve capital for future financing rounds.

Some funds employ associates or principals or venture partners, and these individuals can function as extensions of the fund in helping evaluate startup companies. These "fund extenders" are usually not voting members of the fund, so the startup must eventually have the support of voting partners.

The founding team should check references of a venture fund that is interested in investing. Understand if the fund has a favorable reputation for being fair, and for adding value to their portfolio companies.

THE DECISION PROCESS OF A TYPICAL VENTURE CAPITAL FUND

Before making an investment in a start-up company, a venture fund will usually undertake most of the following activities:

- Read the business plan to help decide whether or not a meeting with the company is warranted.
- Schedule a presentation by the founding team to all (or a subset) of the partners. (This can be conducted by phone if the company is not local, or if the fund wants further validation and understanding before scheduling a meeting.)
- Sometime after the presentation by the startup, the partners of the fund will decide whether or not they're interested in taking the next step in evaluating the startup company. The fund should let the founding team know who will be responsible for evaluating your startup company.
- Assuming the fund is interested, a partner (or a team) will begin due diligence, which includes an analysis of the factors listed earlier. Some funds will conduct preliminary due diligence before offering a term sheet. Others will present a term sheet, noting that due diligence on intellectual property will occur prior to closing a financing.
- The fund will discuss the company at subsequent partners' meetings, so long as nothing has been uncovered that disqualifies the company from consideration as an investment. If the fund reaches a negative conclusion, the fund should notify the company as soon as possible so management can focus fundraising efforts on investors more likely to provide capital.
- When fund management decides to offer a term sheet for investment, the partner assigned will work with legal counsel to prepare a term sheet, which usually will be approved by the fund according to whichever approval process they employ.

> The founding team will want to understand the process the fund uses in voting whether or not to invest in the startup. Assuming a number of partners N, here are some of the alternative ways in which funds decide on whether or not to invest.
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> - All N must vote in favor
> - N – 1 vote positive, allowing for one dissenting member
> - A consensus of the fund partners
> - One senior partner controls the fund, and his/her vote must be positive

The term sheet will include the amount the fund intends to invest, terms under which they are willing to invest, and an indication of the total size of the financing.

A partner of the fund will present the term sheet to the management of the startup, usually in person so that the reasons for the terms can be defined

Management will usually review the proposal with their legal counsel before responding to the fund.

After reaching agreement on the terms of investment, the founding team and lead investor will often work together to find other investors to join the syndicate and get commitments from other funds for the total amount to be raised.

Venture firms sometimes have difficulty telling startups that they do not intend to invest; they either want to keep open the option to invest if something positive happens to the company, or they want to avoid delivering the news that they do not intend to invest. It is helpful to the startup if the potential investors are frank and tell the company whether or not they will invest as soon as they reach a conclusion.

Here are some telltale statements that a venture fund might make, suggesting they are not interested in investing in a startup company. What they likely mean is shown in parentheses.

"We have a lot on our plate." (We're too busy to devote time to evaluating your company.)

"We're raising money." (We don't have any capital to invest.)

"It'll take us awhile to get up to speed." (We don't have a clue as to what your company plans to do.)

"Call us when you have a lead investor and a term sheet." (We're a follower, and we don't want to invest any time with you until another fund shows interest in investing in your company.)

"We've never invested in companies such as yours before." (And we never will.)

"We have capital available for only one or two additional portfolio companies." (You will not be one of them. In fact, we're not really making new investments, but we don't want our network to know we're not in the market.)

No contact from the fund indicates a lack of interest, unless founders were told there would be a delay in contacting them. This suggests the company is not a high priority for the fund.

OTHER ISSUES

Confidentiality Agreements

Very few funds will sign confidentiality agreements. If this is a condition that a startup team believes is too important to waive, the management of the startup might want to consider alternative sources of funding. There are legal reasons for funds unwillingness to sign confidentiality agreements which a patent attorney can explain. A venture fund which became known for misusing confidential information in any form would soon ruin their reputation and destroy their deal flow.

Vesting of Founders' Shares

Even though the founding team members may have been working on starting the company and developing the initial products for months or even years, the venture funds will require that some of the founders' shares be subject to vesting. Funds will sometimes vest a portion (usually in the range of 10% to 25%) of the founders' shares upfront, with the remainder vesting monthly over 4 years, or 1/48th of vesting shares per month. If founders leave the company before being fully vested in their allocated shares, the unvested shares are returned to the company for use in recruiting others to fill the vacated positions. Venture funds need to ascertain that the founders they back are committed to working for the startup until significant value has been created, and until their leaving will not be fatal for the company.

Undesirable Terms

Funds which incorporate punitive conditions in term sheets are less likely to be offered the opportunity to invest. Among punitive conditions are full participation in proceeds after return of invested capital in a liquidation of the company, participation in proceeds at multiples of the amount invested, unilateral voting rights or blocking rights, and full ratchet anti-dilution provisions.

One of the most difficult issues for founding teams occurs when an investor inserts a term that gives the investor a greater ownership position if performance milestones are not met. These types of milestones can drive management teams to pursue objectives which fail to optimize overall company performance and value creation.

Funding to milestones is very risky for a startup with many unknowns. On the other hand, venture funds can increase their rates of return by investing the cash only when needed by the company. Funding investments based on the calendar can work for both parties, e.g., the fund invests $2 million at first closing and invests the second $2 million tranche of a $4 million investment within 9 months of the first closing.

Managing the Fundraising Process:

Funds which invest in both high technology and life science companies might require more time to reach a decision. The founding team should determine if the approval of both groups is essential for the fund to make an investment.

Founding teams should check with each venture fund weekly to determine where the fund is in their evaluation process. If a fund is not showing interest in investing, the team should consider contacting additional funds.

It is not advisable to disclose the names of other funds which are evaluating the startup until a term sheet has been offered and accepted. Negative perspectives on the company might sway others who are still evaluating the company. When a term sheet has been signed by the company and the fund, the startup team can work with the lead investors to identify other funds that are acceptable to both parties. Both can then let others who are in the evaluation stage know that a lead investor has come forward, and additional funds are welcome to join the syndicate.

It will usually take anywhere from two months to 12 months, and more typically from four to six months, to raise a first financing. During this fundraising process, most of the time of the senior management will be devoted to raising capital. Plan accordingly.

SUMMARY

Founders of a startup should prepare for the initial fundraising before contacting carefully targeted prospective investors. When meeting with these funds, the team can ask the funds to explain the steps the fund will make in deciding whether or not to invest. The startup team should pay close attention to what is being said and done by prospective investors; don't waste time on those prospects who don't appear engaged.

Solicit more than one term sheet so the company is not forced to accept undesirable terms. Acknowledge that during fundraising it will be difficult for founders to find time to develop products and begin building the company. If the startup succeeds in raising sufficient capital at an acceptable valuation under market terms, all the effort devoted to fundraising will have been worthwhile.

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