Chapter 8

VENTURE CAPITAL

INTRODUCTION

The venture capitalist has a unique role in capital formation. At one level they are financial intermediaries bringing together institutions with capital to invest and companies that need capital and cannot get it from other sources. At another level, they drive companies to push harder and faster than they ordinarily would, sometimes creating substantial wealth and value. A venture capitalist can make an entrepreneur tremendously rich or he or she can take an entrepreneur's company away from him or her, or the venture capitalist can do both. So who are these people and what do they want?

If we want venture capitalists to invest in our companies, we must understand how they operate, how they think, their goals and their expectations. This chapter discusses who venture capitalists are, how venture capital firms are structured, what they want, when a company should consider venture capital, and how to find the right venture capital firm.

This chapter will also analyze the types of firms venture capitalists invest in, explore their investment criteria, discuss the benefits of and drawbacks to using venture capital, and contrast venture capital with angel investors. One study suggests that the more an entrepreneur knows about the venture capital process, the greater their relative bargaining power.[1] More power means an entrepreneur will have more control over the terms, conditions and the amount of the investment and he or she can minimize the relative cost.

RISK VERSUS REWARD

Two of the overarching factors that organize capital markets are the tradeoff between risk and reward. Each source of capital has a different risk/reward profile. Broadly speaking, venture capitalists are more risk tolerant than banks, bondholders, and thoughtful investors in publicly traded companies. This risk tolerance springs from two sources. Their first is the need to generate superior rewards for their investors and superior rewards usually accompany increased risk. The second is their belief their superior skill and knowledge will enable them to safely select and manage investments bearing substantial risk. Broadly speaking, they are less risk tolerant than the majority of angel investors, friends, family and entrepreneurs. These groups accept more risk than venture capitalists, not because it is their intention, but because the lack the skills and experience to prudently evaluate risk in a meaningful way.

Venture capitalists face several kinds of risk, of which agency risk is one of the most important. When a venture capitalist commits funds to a company, the entrepreneur becomes in some sense the agent for the venture capitalist, responsible for prudently managing his or her company, and thereby managing invested capital. One way to control this risk is through an investment agreement that gives the venture capitalist the right to replace an underperforming, incompetent or dishonest entrepreneur.

Another way venture capitalists protect themselves is through a stringent analysis of the business and its prospects prior to committing funds. This analysis involves a detailed assessment of the marketplace, competitors, threats and opportunities and exit strategies. For example, the venture capitalist might identify two or three companies that might be interested in purchasing the portfolio company prior to making a commitment of funds. This analysis is followed by a due diligence review.

Due diligence is designed to confirm that everything an entrepreneur has told them about the company is true and accurate and that no material facts have been omitted. It also involves a check into the entrepreneur's personal background and credit history. If they see downside risk during this review, and can't come up with a plan to manage it, they may simply step away from the deal.

Another strategy is to share the risk with other venture capital firms. If other firms join in, less capital is at risk and collaboration provides confirmation that the venture capitalist has not overlooked some key weakness in the deal. Finally, they require sufficiently high rates of return so that if some of their portfolio companies collapse, the others will generate enough of a return to prop up the venture capital firm's overall return.[2]