

HOW TO CHOOSE AND APPROACH A VENTURE CAPITALIST

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In the aftermath of the dot com and telecom meltdown, venture capital firms (“VCs”) are very cautious about whom they back and what they fund. While significant amounts of money are available for investment, the venture capital industry is only cautiously putting money to work. It is therefore essential for entrepreneurs to select the right VCs to approach, obtain a credible introduction and be properly prepared for the VC meeting in order to succeed in the fundraising process.

Choosing the Right Venture Capital Firm

Identifying the most appropriate group of venture capitalists to approach is critical. It is surprising how little research many entrepreneurs conduct before they begin the time-consuming task of raising capital. Two problems can result from approaching venture capitalists unprepared. First, once an investment opportunity is rejected, it is very difficult to get it reconsidered, even with a proper introduction. Second, if an investment opportunity is rejected by a number of firms, it may get an “over-shopped” reputation. Venture capitalists frequently share investment information and a turndown by one firm may influence others.

Gathering preliminary information to narrow the field of potential VC firms is key. The internet makes collecting background information on venture firms quite easy. Information on a VC’s website is a good starting place. Specifically, an entrepreneur should set out to gather information on VCs based on five factors: geographical location, stage of development preference, investment level parameters, industry focus and whether the firm prefers to lead investments. This information is important as it provides five ways for choosing venture capital firms that are most likely to respond to your business plan.

The first filter you should apply is geography. If you are based in an area well served by venture capital, a “local lead” investor is critical. If you cannot attract a “local lead,” you will have a more difficult time raising capital elsewhere. Although there are many firms investing nationwide, the closer the venture capitalist is to the investment, the easier it is to “add value” and to “monitor” the investment, especially in early-stage companies. Today, virtually every region of the country is home to experienced venture capitalists.

Secondly, many venture capitalists have a *stage of development* bias. There are some who prefer the seed capital arena while others are only interested in later-stage investing. Make certain that your company’s stage of development matches the stage preferred by the venture firm, which you are approaching. One word of caution: many in the venture capital industry invest in “startups” but definitions vary between firms. A start-up for one firm can actually be a later-stage investment for another. So beware of inconsistent uses of stage of development terms.

The third criterion is *amount of capital* needed. There are many firms that have an upper and lower limit to the size of an investment. If your project falls far outside a firm’s range, it is better not to approach them. Also, it is unwise to inflate the amount of capital you need to meet their minimum. Some venture capitalists shy away from very large

dollar syndications and prefer to invest a smaller amount to give them a meaningful position in an emerging company. These firms may be more appropriate for your initial requirements.

The venture capital industry is witnessing greater *industry specialization* than ever before. This is the fourth filter to apply to your search. There are venture capital firms and individual venture capitalists that specialize in medical technology, communications, consumer products and distribution, for instance. Clearly, if a venture capital firm has a stated investment preference in your industry, not only is it more likely to understand your opportunity, but it will also be in a position to add value to your company. This industry expertise is often acknowledged and respected by other VCs that may provide additional funding. In addition, a number of venture capital firms have excluded certain investment categories such as real estate or oil and gas.

Finally, in every successful venture capital financing, there is a need for *venture capital leadership*. There are a number of funds who are active investors and are willing to lead a financing while others serve as passive investors. In order to complete a syndication, you will need venture capital leadership. It is unwise to approach passive investors until after a lead investor is identified. Therefore, try to identify venture capitalists that take early leadership roles in syndications similar to your opportunity.

Using these five criteria as a basis, prepare a target group of venture capitalists. Make certain that this target group is a reasonable size. (No one likes to receive a business plan that is number 128, knowing it has been sent to a broad audience.) A simple matrix may assist this effort. For example, subjectively rate a venture firm's investment orientation as it relates to your firm's needs. Let two (2) represent a good match, one (1) represent an acceptable match and zero (0) represent a poor match. The VCs with the highest ratings should be the initial targets.

	<u>VC #1</u>	<u>VC #2</u>	<u>VC #3</u>
Geography	2	2	1
State of Development	2	2	2
Capital Required	1	0	2
Industry Focus	2	0	2
Leadership Position	<u>0</u>	<u>1</u>	<u>2</u>
Total	7	5	9

Obvious trade-offs occur. Which is more important, industry focus or geography? In the above example, however, VC #3 is probably the most likely firm to approach, VC #1 should be approached after the lead investor had been identified and there is no apparent reason to contact VC #2.

By applying this method, you can successfully narrow your VC targets. However, before you approach a targeted venture capital firm, research it thoroughly. Learn as much as possible about the people who lead the firm and the companies it has funded. In addition to websites, most firms publish brochures which offer more information. A phone call can usually get you a copy of the brochure. This information has been thoughtfully prepared

to generate investment opportunities that fit the firm's interests and to discourage opportunities that do not.

This background information will further qualify the types of investments the VC has made. Venture capitalists' past successes can offer insight to their areas of personal interest and expertise.

Once the target group has been identified and the firms have been researched, it is now time to approach the venture capitalist.

How to Approach the Venture Capitalist

The *best* way to approach a venture capitalist is through a *quality introduction*, because venture capitalists are more likely to turn down an unsolicited business plan. This introduction may be through a banker, a lawyer, an accountant, another entrepreneur or even another venture capitalist. If your banker, lawyer or accountant appear unwilling to provide an introduction, their hesitancy may indicate doubts about the financeability of you and/or your product. If your contact does not know venture capitalists, you may have the wrong banker, lawyer or accountant.

If you are well known by a successful entrepreneur who has received funding from a specific venture capitalist, this is often the best introduction as venture capitalists pay particular attention to such contacts. Be careful with venture capital references, however. If one venture capitalist you ask for an introduction has turned you down, others will want to know why. If a venture capitalist whom you ask is a passive investor, but introduces you to an active investor with the comment "if you invest, we want to do it with you," this can be very positive. (The same holds true even if a venture firm is fully invested and is not currently making new commitments.)

Be sure to prepare the person making an introduction. Provide them with an executive summary that clearly highlights the opportunity. Remember, they are selling on your behalf – help them be successful.

Finally, if you use someone's name as a means of introduction to a venture capitalist, make sure you have permission to do so. Every venture capitalist will call your reference before meeting with you – if they aren't a supporter of you and your idea, you will lose significant credibility.

The Purpose of the Initial Contact

The initial contact following the introduction should be by telephone. The purpose of the telephone call is to get the venture capitalist to request your business plan and to get that business plan read upon receipt. There are a number of articles and books on writing a business plan and a number of service organizations - including accounting firms, consultants and investment bankers – specializing in business plan preparation. It should be clearly understood that initially *the sole purpose of the business plan sent to a venture capitalist is to get a meeting*. Let the significance of a meeting be clear. The majority of business plans received by a venture capitalist are turned down after the initial reading. In a typical scenario, a VC may receive 500 plans in a year, meet with only 60 teams and fund 3-5 ideas.

The business plan should be concise, well written and include a summary that covers the following five essential points:

- (1) What is the market and growth opportunity? Different risk profiles exist for business plans in established markets versus ideas aimed at creating a new market. An entrepreneur must be able to clearly articulate the existing market dynamics and why strong growth can be expected over the next five years.
- (2) Who are the people on the management team and why are they qualified to succeed in the endeavor? Many venture capitalists state that they invest in people before products or markets. Therefore, to build a credible case, the people who are responsible for making it happen must be highlighted.
- (3) How well has the business done? Any business, even a seed capital entity, has a history. Detail this history and describe what has been done with the time and resources to date. In today's market, many venture capitalists are leery of investing in conceptual business ideas. Entrepreneurs are being rewarded for well developed ideas which include a completed product and beta customers.
- (4) What is the company's unique competitive advantage? The era of "first mover advantage" has lost its appeal to most venture capitalists. While "me too" investments are no longer funded, it is still essential to demonstrate a solid value proposition for your target customers and a clear advantage over other product solutions and competitors.
- (5) How well do you expect it to do? Most businesses do not meet a venture capitalist's expectations because of the size or scope of the potential business. As a rule of thumb, a company should have the potential to return at least 10X the initial investment within three to five years to be of interest.

Unfortunately, in the initial review venture capitalists generally look for reasons to turn down an investment rather than search for reasons to invite you for a meeting. For example, typographical errors, incomplete or erroneous market information and ill-conceived organizational structures are all potential negatives.

Finally, many business plans don't "sell" the idea. Too often business plans lead investors to conclusions that are inaccurate. It's helpful to include an investment highlights page at the beginning of the plan which clearly articulates the business, market, product, management and other success indicators. Make it easy for the venture capitalist to understand your business.

Meeting the Venture Capitalist

If a meeting has been set up, be prepared to make a formal presentation. Bring a PowerPoint presentation, which has been tailored to address questions that arose during your initial telephone calls. However, be prepared to deviate from this agenda if necessary. Never answer a question with "we will be getting to that later in the presentation." Demonstrate that you can be agile. The venture capitalist is using the meeting to learn about the product and market but is primarily focusing on evaluating you and your team. Remember, you may have limited time to make a positive impression and to leave the venture capitalist enthusiastic about your company.

The entrepreneur should also use the meeting to size up the venture capitalist. Do not hesitate to ask a prospective investor for references, especially names of other portfolio entrepreneurs. Call them, find out how well they have worked together from the entrepreneurs' perspectives.

Deepening the Relationship with the Venture Capitalist

Once you have met with a venture capitalist, you will have to work hard to keep their attention. Always have a reason to call the venture capitalist, rather than simply asking about the status of your business plan. Offer "good news" updates on the progress of your business. Make their learning process about your market and product as easy as possible. If they have questions or concerns, follow up with relevant research or information that addresses their issues. Suggest that the venture capitalist call customers (or beta customers), as this is always useful information. In addition, if you have industry experts on your advisory board, suggest that you arrange a call. If you think that your product or service would be particularly useful to one of the VC's existing portfolio companies, suggest that the VC introduce you to the company so they can evaluate your product. This is one of the most credible means for a VC to secure validation on your product. Ultimately, it is your responsibility to keep the VC's attention and push your plan through the due diligence process. Don't let your plan stand idle in the stack of other plans.

In today's venture capital marketplace you must be even better prepared to successfully compete for VC dollars. It is the task of the entrepreneur to prudently select and approach the venture capitalist. If this is done wisely and systematically, you will improve the odds of finding a venture investor.

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