

PART ONE OF A THREE PART SERIES

The venture equation

A venture capitalist explains what his industry is looking for — and what companies can expect from the investment

BY MICHAEL GURAU

At a recent Financing Growth seminar I gave in the northeast, one attendee asked about financing her single-location pet hotel concept. I'm getting accustomed to fielding this kind of question in northern

Capital sources in Maine

Small Business Innovation Research

Type of capital: Federal grants
www.sbirworld.org

Maine Technology Institute

Type of capital: State grants
www.mainetechnology.org

Maine Angels

Type of capital: Angel investment group
www.maineangels.com

CEI Community Ventures

Type of capital: VC fund targeting businesses in ME, NH and VT
www.ceicommunityventures.com

CEI Ventures

Type of capital: VC fund targeting businesses in northeast
www.ceiventures.com

Small Enterprise Growth Fund

Type of capital: VC fund targeting businesses in Maine
www.segmaine.com

Borealis Ventures

Type of capital: VC fund targeting technology businesses in ME and NH
www.borealisventures.com

Masthead Venture Partners

Type of capital: VC fund targeting technology businesses nationally
www.mvpartners.com

North Atlantic Capital

Type of capital: Mid-late stage private equity fund
www.northatlanticcapital.com

New England, where I earn my keep looking for venture capital-worthy investment opportunities for CEI Community Ventures Inc. Unfortunately for that attendee, a pet hotel is not the type of business typically funded by venture capitalists. The fact is, precious little traditional venture capital reaches Maine. The latest Pricewaterhouse Coopers Money Tree venture capital survey reported that only one Maine company received a deal in 2005. Why?

In part, this dearth of deals may be due to Maine's location and its distance from both capital sources and experienced startup management. Maine is considered remote even by Boston standards, with a perceived disadvantage in attracting talent and the commute from the south being barriers for out-of-state VC attention; there are a handful of smaller VC funds within Maine (see "Capital sources in Maine," this page), but overall few early-stage investors are willing to take the risk (and the reward) of working with entrepreneurs here at the earliest stages of formation. Likewise, there's little investment capital that's willing to flow to non-traditional venture capital sectors such as consumer products, rather than technology — a sector in which Maine is a relatively small player.

Yet growing a business can be an expensive proposition, often requiring you to invest ahead of next year's revenue to fund hiring, research and development, sales support, inventory, etc. Finding yourself in this situation, you are bound to ask: Where will I get the capital I need to cover my losses? When should I raise the money I need? How fast should I grow my company?

Most business owners default to a growth rate dictated by their profits. And for many, this is not only practical but prudent — bootstrapping, as this technique is called, can allow time to mature a business and a management team. For certain types of companies, bootstrapping makes sense.

PHOTO/DAVID A. RODGERS



Michael Gurau, president of Portland-based CEI Community Ventures Inc.

A service business such as a consulting operation can manage to grow one customer at a time.

By contrast, a fast-moving software business or a consumer product business, such as a natural-food startup in a category that does not have a natural-food equivalent, must fund its growth at a faster rate to protect against a bigger or better-funded company getting to the Promised Land before it does. In other words, grow too slowly and you may lose your market opportunity altogether to competitors. In these cases, you may have no choice but to fund product development, staff and infrastructure ahead of revenue.

So, how does a company fund growth and startup needs with outside capital? First, it's important to recognize that there are many sources of external capital, venture capital being among the most difficult to access and not for

everyone. Most company owners start with personal assets, credit cards and mortgages. After tapping out those sources, many turn to people close to them, affectionately known as friends, family (and fools). Other sources of so called cheap capital can come from state or federal grants and loans, if available. (See "Funding alternatives," page 15.)

When a company has exhausted its options or needs more capital, it then may be appropriate to consider external funding that may include equity capital — investments funded by wealthy individuals or venture capital funds. While most business owners understand loans and grants, few understand equity and equity investors. Basically, an equity investor takes high risks by placing money in young companies serving (preferably) large, fast-growing markets with unique products or services. These investors typically trade capital for minority — 20% to 45% — ownership interest in the growth company.

Making a match

Venture capital investors, particularly those focused on early stages of growth, tend to make money on only one in every three investments they make. The other two become either complete write-offs or investments where the investor is simply lucky to get his or her original capital back (known in the industry as the "living dead"). Given this investment return outlook, investors spend a good deal of time assessing a company's operating risk issues, such as its management team, business model and strategy, so as to gauge investment risk. This investment risk will translate into a target return and, implicitly, a valuation

assessment of the company at which the investor believes he or she is fairly compensated for the risk taken.

The valuation sets the basis for the percentage of your company you will need to give up in order to attract capital — i.e., if I value your business at \$1 million "pre-money" (before investment) and I invest \$500,000, then I would own one third of your company, which is now valued at \$1.5 million following investment ("post-money."). (I'll explain the valuation process in more detail in the next installment of this series.)

So, how can you tell if your business is ready for VC investment? Apart from the standard business plan elements — market, management, product, etc. — the vast majority of early-stage VCs tend to prefer businesses that are at the point of commercialization, earning revenues and with customers to speak to, rather than in the R&D, or pre-revenue stage. Market reports and hockey-stick spreadsheets are nice, but the best advocate for your business will be excited customers raving about your product and insisting that it is a "need to have," not a "nice to have."

Vcs also like to see businesses with at least a couple of the key members of the management team, such as a CEO and chief technical officer, in place. Finally, VCs like businesses for which the path to realizing some value for their investment (the exit strategy) is clear. VCs typically expect the exit strategy to be the acquisition of the company by a larger business or a public market stock offering.

From a sector perspective, technology businesses such as hardware, software and Web ser-

vices companies, or life sciences operations tend to attract the vast majority of capital in this country. There are, especially in Maine, funds that are open to non-traditional sectors, such as consumer products, service businesses and retail. However, these represent the minority, given the comparatively faster growth rate and higher gross margins offered in technology businesses.

Accessing capital for non-traditional sectors generally requires that you have more of the risk areas — team, product, plan — covered. Most VCs would sooner take a technology deal with incomplete management than a consumer deal with an experienced team and a well-developed plan. The venture economics — higher margins enabling self-funding, less secondary financing risk, high value exit options — are simply more attractive in the former than the latter.

In summary, Maine has a lot going for it in terms of federal and state grant opportunities, small tech and non-tech oriented funds and an unbeatable quality of life. Business owners with true growth opportunities ought to be aware, however, of the challenges that location, sector, stage of development and team makeup can present to finding the all-important capital to grow your business. Be scrappy, be creative, be persistent, be prepared and, above all, be realistic when trying to meet your capital needs.

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Funding alternatives

PROS

CONS

FRIENDS AND FAMILY

Easy to access; not valuation-sensitive; tend to be passive

Low/no value-add; Can have an emotional toll at holiday gatherings if things are not working out

FEDERAL/ STATE GRANTS

Often an outright grant or success-dependent loan

Typically, more bureaucracy in applying and reporting; may be difficult to find capital source to match your business

BANK

Inexpensive, largely passive capital

Requires personal guarantees; company typically needs to be cash-flow positive and/or profitable; interest payment starts after loan

VENTURE CAPITAL

Patient, value-added capital; tolerance for high risk; low/no current payment required (cash payments/returns tied to success at the end of the venture growth cycle)

VC investors need high rate of return, making capital expensive (must give up much of your company); VC partners are active partners, which has good and (for some entrepreneurs) not so good consequences