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WHAT IS VENTURE CAPITAL??

Growing your business or starting from scratch needs capital!

Venture Capital is a means of financing fast growing private companies, either for a start-up, development/expansion or purchase of a company through a management buyout or buy-in.

There are a number of different ways to fund growth in a new business and these include the business owners personal capital, arranging debt finance or seeking an equity partner i.e. venture capital

With venture capital, the investment firm acquires an agreed proportion of the company's equity in return for the requisite funding. Equity finance offers the significant advantage of having no interest charges, instead seeking a return through long-term capital gain.

When venture capitalists invest in a business they become part-owners and typically require a seat on the company's board of directors. They intend to take a minority stake and act as mentors and provide support and advice on a range of management and technical issues to help develop the company's full potential.

Surveys both in Australia and abroad consistently rate management input as the most important contribution of a venture capital firm.

There are many sources of capital but only a venture capitalist can provide experienced management input gained by helping many other companies conquer the inevitable problems and growing pains.

HOW DOES THE VENTURE CAPITAL INDUSTRY WORK?

Venture capital firms typically source most of their funding from large investment institutions such as superannuation funds and banks. These institutions invest in a venture capital fund for a period of up to 10 years.

The venture capital industry in Australia has an industry body - The Australian Private Equity & Venture Capital Association Limited - ("AVCAL") (http://www.avcal.com.au/) have in excess of 50 members who (jointly) have (as at September 2010) around A$2.5 billion under management.

> ***In the last 10 years, venture capitalists in Australia have funded over 400 high-potential, high-growth and high-tech companies. Many of them are now world-class products such as cancer drug developer Chemgenex, dermatology drug developer Peplin, tinnitus device maker Neuromonics, wind energy company Windlab, solar power provider Ausra, provider of IT security software and tools Wedgetail, and web-based travel company Travel.com.au***.*(Source - AVCAL Website)*

To compensate for the long-term commitment, investment institutions expect to receive very high returns on their investment. Therefore, venture capitalists invest in companies that have the ability to quickly repay a high level of debt – as in the case of a leveraged management buyout.

Venture capitalists typically exit the investment through the company listing on the stock exchange, selling to a trade buyer or through a management buyout. Their primary return on investment comes from capital gain when they eventually sell their shares in the company, typically 3 to 7 years after the investment. Venture capitalists are therefore in the business of promoting growth in the companies they invest in and managing the associated risk to protect and enhance their investors capital/

SELECTING AN INVESTOR

AVCAL represents most venture capital organisations in Australia with its Directory of Members providing basic information about each member's investment preferences.

Before selecting a venture capitalist, you should study the particular investment preferences set down by the venture capital firm. Often they have preferences for particular stages of investment, amount of investment, industry sectors and geographical location.

Once a short list of potential venture capitalists has been drawn up, it is a good idea to contact the firm and request a copy of their publications to clarify the investments they favour. Finally, when choosing a venture capitalist, you should consider the additional value that the venture capitalist can bring to the company. These skills may include industry knowledge, fundraising, financial and strategic planning, recruitment of key personnel, mergers and acquisitions and access to international markets and technology.

WHAT DOES A VENTURE CAPITALIST LOOK FOR WHEN INVESTING?

Venture capitalists are considered higher-risk investors and they desire a higher return on their investment. They manage the risk-reward ratio by only investing in businesses that fit their criteria and after having completed extensive due diligence.

Venture capitalists have differing operating approaches. These may relate to the location of the business, the size of the investment, the stage of of the company, industry specialisation, structure of the investment and involvement of the venture capitalists in the company's activities. An entrepreneur should not be discouraged if one venture capitalist does not wish to proceed. The rejection may simply reflect the venture capitalists particular investment criteria.

A venture capitalist typically seeks the following: - superior businesses; quality and depth of management; corporate governance and structure; appropriate investment structure and an exit plan.

SIZE OF INVESTMENT

On the whole, early stage investments require less capital than an expansion or MBO stage. There are a number of venture capital firms that specialise in investing in particular stages or MBO's or MBI's. While each venture capitalist will have their own investment range, as a guide, venture capitalists invest between $1 million and $10 million.

INDUSTRY SECTORS

The Australian venture capital industry invests in a wide range of industry sectors. According to surveys undertaken the most popular industries are: - manufacturing, computer software, internet, distribution/retailing, technology services, business services and communications.

Some venture capital firms specialise in particular industry sectors such as manufacturing, bioscience or information technology. Many venture capital firms will actively avoid investing in sectors such as property, mining and farming, which are unstable. In Australia venture capitalists do tend to have investments in many geographic locations, focussing on a company's attributes rather than accessibility.

APPROACHING THE VENTURE CAPITALIST

Once a short list of appropriate venture capi6talists has been selected, an approach can be made. The firm will ask prospective companies for information concerning the product or service, the market analysis, how the company operates, the investment required and how it is to be used, financial projections and questions about the management team. In reality, all of the issues noted here should be answered in the business plan.

THE BUSINESS PLAN

Venture capitalists view hundreds of business plans every year. Your plan must therefore convince them that the company and the management team have the ability to achieve the outlined goals within the specified time.

The length of the plan depends on the circumstances but as a rule, it should be no longer than 10 pages. It is important to use plain English – avoid jargon and generalisations.

ESSENTIALS FOR YOUR BUSINESS PLAN

Executive Summary

This summarises your business plan and it is vital to give this significant thought as it may well determine the amount of consideration the investor gives to your proposal. It should be clearly written and powerfully persuasive, yet balance "sales talk" with realism. It should be limited to no more than two pages and include the key elements of the business plan.

Background

Provide a summary of the fundamental nature of the company and its activities, a brief history and an outline of the company's services.

The product/service

Explain the company's product or service in plain English, especially if it is technical. Emphasise the competitive edge or unique selling point. Describe the stage of development. Consider the following: - scope for a second-generation product; technological advances/redundancy; legal protection such as patents.

Market analysis

In this part of the plan you need to offer a description and analysis, including a realistic "SWOT (strengths, weaknesses, opportunities and threats) analysis. Define your market and explain in what industry sector your company operates in while considering the following: - the size and development of the market; how your company fits in; competitors (strengths and weaknesses) and barriers to new entrants.

Describe the distribution channels and who your customers are. Explain the historic problems and address the current issues, such as risks affecting your business and the industry.

Marketing

Outline your sales and distribution strategy including your sales force, strategies and unique distribution channels. Identify overseas market issues and resolutions. State your pricing strategy. Describe advertising, PR and promotion plans.

The Management Team

Demonstrate that the company has the appropriate management to turn the plan into reality. The senior team should be experienced in areas such as management strategy, finance and marketing, and their roles should be specified. The abilities of each member has should be explained and an organisation chart provided, including auditors and other advisers. A concise resume should be included for each team member, highlighting their track record in running, or being involved with, successful businesses.

Identify current/potential skills gaps and explain how you aim to fill them. Explain your controls, performance measures and remuneration for management, employees and others.

Financial Projections

Consider an external; accountant to verify this part of the plan. AVCAL has a range of corporate members who could help you.

Realistically assess sales, costs, cashflow and working capital. Produce a pro-forma profit and loss statement and balance sheet. Ensure these are easy to update and adjust. Assess your present and prospective margins in detail and explain the research undertaken to support these assumptions.

Demonstrate the company's growth prospects over, for example, a three to five year period and present differ scenarios for the financial projections of sales, costs and cash flow for the short and the long term.

Ask "what if ?" to ensure that key factors and their impact on the finances required are carefully and realistically assessed – and keep the plan feasible. Relevant historical financial performance should also be presented.

Amount and use of capital

State how much finance is required by your business and from what sources (i.e. management, venture capital, banks and others) and explain the purpose for which each will be applied. Outline the capital structure and ownership before and after financing.

Exit strategies

Consider how the investors will strategically exit the investment and make a return on their input. Possible exit strategies may include floating the company on a stock exchange or selling the business on to a trade buyer.

INVESTMENT PROCESS

The process begins with the venture capitalist conducting a review to determine if the proposal fits with the firm's investment criteria. If so, a meeting will be arranged with the entrepreneur/management team to discuss the business plan.

Preliminary screening

The initial meeting provides an opportunity for the venture capitalist to meet the entrepreneur and key members of the management team to review the business plan and conduct initial due diligence on the project.

Negotiating investment

This involves an agreement between the venture capitalist and management of terms of the memorandum of understanding. The venture capitalist will study the viability of the market to estimate its potential as well as looking at the competitors, entry barriers, niches, product life cycles, distribution channels and export potential. The due diligence continues with reports from accountants and other consultants.

Approvals and investment completed.

The process involves disclosure of all relevant business information and final terms can then be negotiated and an investment proposal submitted to the board of directors. If approved, legal documents are prepared. A shareholders agreement is prepared containing the rights and obligations of each party. This process can take up to three months or longer so it's important to plan ahead for your business.

BUYING A BUSINESS

Venture capitalists can assist you in buying a business either by a management buy-out of the business you are running or a management buy-in of a suitable business in an area chosen by you.

Management Buy-Out ("MBO")

A management buy-out is a transaction where a business is purchased by its existing management team with the help of outside investors like venture capital firms. It gives you the freedom to manage your business and a financial stake in the results. You would take control. The existing owners of the business might be attracted to this as a way to realise the value of their holding and step away from the business. This kind of opportunity is rare.

If you are a business manager and see an opportunity, your first step may be to approach the existing shareholders to see if they are willing to sell their company to you. Once you have reached an in-principle agreement with the shareholders and have the support of investors, you can move on. The transaction could be long and complicated, but it could also end up with you being in control of your own business as a manager and important shareholder.

Management Buy-In ("MBI")

If you see a business that might reward a new investment and a new management team, you should consider a buy-in. In this instance, a manager or team of managers from outside the company finds the financial support to buy the company.

There is also a substantial amount of money set aside for working capital, to fund new growth. In many MBI's, new managers take over the company to launch major new projects. The biggest factor in a successful MBI is management talent, which means your skill at putting the MBI deal together and achieving your aims once you gain control of the company. Potential investors will consider your direct managerial experience and your skills when they weigh up the investment opportunity.

Hit the ground running

As soon as you complete the transaction you need to start generating cashflow. Your challenge is not only to reduce debt the company has incurred but also to plan new investments that will achieve growth.

The most likely executives to succeed are those who can demonstrate a record of solid management and entrepreneurial drive. They need a clear vision to take an existing company and transform it, creating a new company with a much greater value. If that is you, then you should start planning your MBI now.

STAGES OF DEVELOPMENT

All businesses have a "life cycle" that involves a number of stages of growth and development. Venture capitalists refer to these stages when making investments and you'll need to include this information in your business plan. The stages are as follows: -

Seed Stage

The company venture is at the idea stage or maybe they need finance for research and development. The entrepreneur's resources usually fund this stage.

Early Stage

The company is being set up or may have been in business for a short time. Investee companies have completed the product development stage and require funds to initiate commercial manufacturing and sales.

Expansion/Development Stage

The company is established and requires capital for growth and expansion. This is a period of rapid growth and the company will usually require several rounds of capital injection.

Management Buy-Out ("MBO") Stage

These are funds provided to enable a current operating management and investors to acquire an existing product or business from a public or private company.

Management Buy-In ("MBI") Stage

These are funds provided to enable a manager or a group of managers from outside the company to buy into the company.