



Venture capital Catalyst for ICT SMEs

<http://www.bgn.org>

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High-technology ventures are unique as they require certain key ingredients, namely:

- Innovative products and/or services based on intellectual property (IP), such as patents and copyrights;
- Products that are priced on value and quality not on cost;
- Significant initial investments of time, money and human resources (typically highly trained and experienced engineers);
- Many man-years of research, development and engineering (RD&E); and
- High barriers to entry (hard to replicate).

Investing in high-tech is a risky business for both entrepreneur and financier. Investment gestation periods typically last three to seven years, the amount of time required for RD&E to develop the product, for sales to grow and for profits to be made. Market risks are due to potential competitors worldwide and short opportunity time windows. Technology risks arise from technical and scientific problems that can be too tough to solve. Trends indicate that only less than 10 per cent of venture-capital-backed high-tech ventures are successful - that doesn't even include those ventures that did not receive funding from the VCs.

Attractive rewards

Nonetheless, financial rewards from successful high-tech startups that succeed are great. Multiples for return on investment (ROI) can range from 10 to 100 times one's principal investment. Other benefits aside from making lots of money are: creating new markets, solving tough real-world problems, and global prestige.

A good success story of a high-tech startup is Chips and Technologies where Dado Banatao was a co-founder (disclaimer: Dado is a NarraVC Limited Partner). Chips, founded in 1984, required several rounds of financing from private equity investors until its initial public offering (IPO) in 1986 at \$ 5 per share. Its shares rose to \$ 24 in 1987, giving seed investors in Chips anywhere from 150 to 760 times, Round 1 investors 8 to 37 times, and Round 2 investors 5 to 24 times ROIs.

Where do high-tech start-ups find their investors? Technology startups generally do not have the size, assets, and operating histories necessary to obtain capital from traditional sources (e.g. stock market and banks). They have to tap investors such as VCs and angel investors (a term for rich individual investors, typically friends and family of the entrepreneurs) willing to put in money in exchange for equity.

Venture capital refers to limited-life funds raised from third-party investors and managed by financial professionals for investing in private companies. VCs naturally prefer to finance

high-tech startups since they give superior returns. Exit from investment through IPO or acquisition by a larger company is very important since funds have to be returned to the investors. VCs are more than just financiers; they bring high-level skill sets and experiences to the high-tech startups by:

- Validating market assumptions;
- Providing strategic and operational advice, at least at the board level;
- Sharing synergies and wealth of experience from their portfolio companies and past startups;
- Sharing global network of contacts crucial to the startup's success;
- Helping recruit talented and experienced personnel for the startup; and
- Helping raise capital from other potential investors in the subsequent rounds.

Technopreneurs wishing to tap VCs for their startups should consider that VCs normally look for three special items - aside from all the other normal components of a standard business plan - namely:

- Large serviceable markets (new or existing);
- Barriers to entry which are normally high-technology solutions that address those markets; and
- An experienced superior team to do the job.

Choosing your VC

Our advice to technopreneurs is to choose carefully which VCs to partner with. While VCs do extensive due diligence on any potential investment, entrepreneurs are themselves advised to conduct due diligence on the potential investors as not all VCs have the same investment objectives, expertise areas, reputations, and management styles. Trust is very important in an investor-entrepreneur relationship; non-disclosure agreements (NDAs) are not to be expected from VCs due to the unreasonable liabilities that would arise from listening to many similar ideas. Entrepreneurs are assured that the best VCs can only survive by honouring the unwritten NDAs.

The initial presentation to VCs should start with a short executive summary before the business plan, focused on the key product, market and the team. Tough questions will naturally arise during the verbal presentation as filtering investments is part of the job of VCs. Be ready for a vigorous and detailed due diligence process and an engagement process that takes from three to six months, on average. It's a mating dance that is important for both parties to take carefully and diligently. □

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Venture capital funds

How to access

<http://www.waldenintl.com>

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Venture Capital (VC) Funds, both domestic and offshore, have been around in India for some years now. However, it is only in the past 12 to 18 months that we have seen intense activity amongst entrepreneurs proactively seeking out venture capital funds. It is interesting to note that for every one investment which is funded by a VC, anywhere upto one hundred ventures are not funded by the same VC. As such, understanding the dynamics behind VC funding is important while seeking funds.

VC funds are broadly of two kinds; generalists or specialists. From the investee company perspective it is critical that the funding be obtained from those who understand the business. This backing of smart money for a growing company can prove to be invaluable as focused/specialized funds open doors, assist in a follow-on round of funding and act as an excellent sounding board on strategy. In a sense, the investee company choosing a Venture Capitalist applies as much as does a VC fund's choice of the investee company.

Venture Capitalists are driven by the profit motive. In effect the VC and the entrepreneur are really on the same side, since VCs do not seek to profit through arbitrage. VC funds invest in the company, with a view to build and facilitate growth. At the time of exit, leaving behind an ongoing concern painstakingly built over 3 to 4 years is a matter of pride for a VC fund. Apart from ensuring returns for its investors such a company serves as an example of the calibre of the VC fund also; a reference of sorts of a good track record. Hence, with a view to derisking the investment most VC's tend to follow a similar set of guidelines, written or otherwise.

As such, while qualifying a potentially winning investee company, venture capital funds look at a select band of generic parameters.

The management team

First amongst such parameters is the quality of the management team, consisting of the entrepreneur as well as professionals in the team. Success or failure of the venture is fundamentally a people game - the best ideas, backed by a great business plan, well funded, cannot be a winner without a winning team.

It is important to distinguish the entrepreneur clearly from the professional management team. In the field of Information Technology, where, in India, the average entrepreneur is around 30 to 35 years of age and reducing, he or she may not possess adequate experience or a track record in the chosen area. The value of the idea, the vision, putting the team together, getting the funding in place, are, amongst others, some key aspects of the role of the entrepreneur. VCs will insist on a professional team coming in, including a CEO to operationalize the idea in the absence of a complete team.

In the overall team, VCs will look for positive reinforcement on personal integrity, transparency as well as leadership, from the team, and more specifically from the entrepreneur.

Many Venture Capitalists tend to be hands-on in a strategic sense and will be with the entrepreneur on the board of the company. In such cases the VC fund manager will seek personal chemistry with the entrepreneurs; a meeting of the minds facilitates the ability to listen to each other out of respect and nothing else, thus facilitating working together to build the company.

In India, since the regulatory framework of transparency and disclosure have a long way to go, strong entrepreneurs also practice and highlight self-imposed high standards of governance.

The idea

The second key factor venture capital funds look at is obviously the idea and the potential of the idea to be monetized resulting in growth in valuations and profit. In effect, the business model. Here key factors include:

- **Scaleability:** Venture funds look for scaleable markets enabling the investee company to also be scaleable in terms of the business model. The scaleability potential, at a country level or a regional/global level is critical in building valuations, revenues and profits. In a scaleable model the presence of dollar revenues provides a hedge against potential rupee depreciation.
- **Competitive entry barriers:** Does the business model allow for adequate entry barriers to competition? Entry barriers in the form of technology, products, and now in terms of speed of entering and securing markets/customers.
- **Creation of value:** Does the business model allow for creation of intellectual property, patents, methodologies, processes and brands, which will add to increased valuations? Increasingly, the value of building brands is becoming critical to valuation increase in a company. In this day of the Internet it is entirely possible for an Indian entrepreneur to think of and build a global company, with speed as a key entry barrier and brand as a major asset. In essence, the importance from a valuation perspective, of softer assets, are increasingly becoming critical for a VC fund.

Valuation

The third key factor is valuations. VC funds are sensitive to valuations whether for a start-up or an ongoing concern. Valuations typically are drawn from parallels in the stock market, business projections and experience. Expectations of valuations by investee companies *vis-a-vis* VC funds will differ. However, the prime driver is not only the state of the business today but also expected returns by the VC fund in the future. In India, while calculating returns, VC funds will take into account issues like rupee depreciation and political instability (such issues tend to suppress valuations today). The presence of intellectual property, brands or predictability of future revenues and profits enhance valuations.

Linked to valuations is, of course, the stake or percentage share of the company, which a VC funds takes. In a seed stage company, where the entrepreneurs bring to the table a great idea in combination with a world class management team and no capital, the VC fund will typically take a stake of above 50 per cent and even upto 70 per cent depending on the funds required, e.g. if the pre-money valuation agreed upon is Rs. 50 million and the fund requirement is Rs. 80 million, then the share of the VC ownership will be 61 per cent. In US markets, this is normal; Indian entrepreneurs are still uncomfortable with the VC "taking control" in a seed stage project. It is critical to understand that the VC is owning stock commensurate with the financial risk being taken.

In early stage or at expansion stage, companies' VC funds tend to take lesser ownership based on valuations determined on factors mentioned earlier.

Exits

A fourth key factor is the issue of exits. For the VC fund to earn, it must exit. Exit can be in the form of a trade sale or an IPO. Here it is essential to structure for tax optimization while in existence. The time frame of the holding is also important. For the investee company and the entrepreneur, life after exit is critical; in the event of an IPO, the VC and the entrepreneur are really creating an ongoing concern with fiduciary responsibility to a larger set of investors. VC funds will discuss exit options at the time of investment.

Multiple rounds of funding

While investing, VC funds look for investee companies, which have got angel funding already. Angel funding is smart funding at the start-up stage. Angel funding also means that the angel has spent time to develop the company. Angel funding is specialist funding, giving very high value addition. Typically, for an early stage, expansion stage or seed stage investment, co-investments by venture funds is a practice increasingly being followed. VC funds with complementary strengths, e.g. one focused on a given sector and the other, say, on a geographical market, are the ones most likely to get together.

One of the key internal requirements of VC funds in deciding upon investments is portfolio balancing. Most VC funds invest in companies at seed stage, early stage and at the expansion stage, in the life cycle of a company. However, if, for example, a VC has invested in a portfolio of companies predominantly at seed stage, VCs will focus on expansion stage projects for future investments to balance the investment portfolio.

Conclusion

In summary, VC funds go through a certain due diligence to select a good investment. The due diligence starts at the management team level and goes on to encompass the idea and the potential of the idea to be monetized as well as exit opportunity evaluations, for a seed company. For a running concern, the above set of due diligence parameters are supplemented by legal and accounting due diligence typically done by an external agency, e.g. one of the Big 5 audit concerns.

In the event of a seed stage opportunity, VCs tend to take upto 2 to 3 months to decide whether to back a project or not; for early stage or expansion stage projects being valued in India, the legal and accounting due diligence cycle itself will add another two months to the final go-ahead signal for a VC fund. Comparatively in a US company, the time cycle is far smaller at less than 30 days in many cases, or an average of 60 days in most cases.

In effect, next time you are going to raise VC Funding, do keep 2 to 4 months from the time fund raising starts to final disbursement for Indian companies, or upto 2 months for US-structured companies. □

China Venture Capital Yearbook 2005

This yearbook is a very resourceful reference book to all the global venture capital firms who are interested in understanding China's venture capital industry in 2004 and outlook for 2005. The book contains China's venture capital industry statistics in 2004, analysis reports on policies and regulations associated with the China venture capital industry, research analysis on China's hot industries (such as software, new materials, telecom and electric power), practical venture capital cases (investment and exit), detailed directories of China's venture capital firms, local venture capital associations, high-tech parks, etc.

The Yearbook, with more than 900 pages, is composed of 7 parts, including Laws and Regulations, Development, Statistics, Special Research Report, Case Studies, Hotspot Industry and Appendices. The Yearbook is issued to the concerned governmental departments, all venture capital institutions, high-tech industry enterprises all over the country and to enterprises (home and abroad) seeking venture capital in China.

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