

VENTURE CAPITAL CONCEPTS

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1. **Purpose of Venture Capital.** This is capital provided by an investment group (often an investment partnership) in a new small and emerging company. Capital is typically provided for a necessary transition in company operations. The investment group is generally local or regional. However, they are increasingly national, as major companies have recognized they can leverage their research and development funds through investment in related new businesses. However, the best opportunity for the typical startup enterprise is to seek a relationship with an independent investment group.

Recent declines in market values have restructured the way in which venture capital investments are being pursued. For example, Menlo Park's Kleiner Perkins Caufield & Byers, a preeminent VC firm, agreed in March of 2002 to release its investors from 20-25% of their capital commitments (according to Private Equity Week). Decreased deal flow has impacted VC firms in recent quarters, and key managers for many of these firms are leaving. Some firms are regrouping. Accenture Technology Ventures (with offices in Palo Alto, London and Kuala Lumpur) recently announced it hired an investment bank to sell its startup portfolio to avoid "volatility in future earnings."

According to the *Sacramento Business Journal* (April 26, 2002), this region has developed a "handful" of VC groups recently, "bringing the total to nine." They have invested in telecommunications, software, digital technology, and a variety of technology plays or medical equipment. In addition, Davis Bioscience Capital recently announced it was seeking funds from CalPERS to provide the base from which to finance its investments in "early-stage life sciences companies, particularly those emerging from research at U.C., Davis." It announced it obtained \$10 million from Japan Asia Investment Co. Ltd. and another \$10 million from other Japanese investors and is hoping CalPERS will commit an additional \$80 million to the fund.

An example of a VC firm's strategic focus is that of Brentwood Venture Capital:

- Building sustainable brands and business models for emerging e-commerce businesses,
- Building the 21st century Internet infrastructure, and
- Creating the medical breakthroughs that will transform patients' lives

What do they look for? They seek companies with first-to-market advantage and large market opportunities. They prefer companies that have a sustainable competitive advantage by offering

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highly differentiated, demonstrably superior products and services. They also claim they bring involvement beyond their capital and board participation by sharing the expertise of their team.

2. **What screening is used?** This will vary with the expertise and track record of the group. One protocol that is used requires a business plan to be rejected from consideration unless six independent tests can be satisfied:

(a) Capital Test. How much additional capital will be required to reach the IPO or acquisition stage? For a venture capital group to achieve a balanced and diversified portfolio, most limit the investments in any one company, and two major factors are considered. The stage of the company's development and the total amount of capital required. This generally means investments will be limited in the early stages of a company requiring over \$15 million, whereas later stage investments in the same firm may be suitable where less incremental cash is needed to reach liquidity. An example of one group's policy is:

- Seed capital for R&D? (\$3-15 million)
- Market development for finished product? (\$3-15 million)
- Need for growth in commercial sales? (\$3-10 million)
- Expansion of new products or new markets? (\$3-5 million)

(b) Financial Return Test. Is an adequate liquidation value present to justify the investment? The group will look to the most likely exit scenario and when it is anticipated to occur. An example of one group's analytical model is:

	<3X	3-5X	5-10X	>10X
Exit in year 3	NO	MAYBE	YES	YES
Exit in year 5	NO	NO	MAYBE	YES

(c) Market Opportunity Test. How attractive is the target market niche in terms of size, profitability, and competition? What is the market size in the 5th year of product sales? What is the expected pre-tax margin on the product sales? What is the number of competitors in the 5th year of product sales? Many good businesses start small and stay small and become very successful. These are not good venture capital investments.

(d) Defensible Niche Test. What advantages does the venture expect to have relative to its competitors? This is difficult to assess, because unique proprietary products are generally essential if a young company will grow to yield venture capital returns. Without a defensible niche, small firms find it difficult to attract market interest. What is considered?

- Product performance
- Cost
- Proprietary technology
- Barriers to entry
- Ease of channel access
- Ease of customer acceptance

(e) Management Test. Is the management team currently or potentially adequate? Factors considered include relevant experience and education, track record, and present team.

- Technical person for product generation
- CEO to run the business, raise money and sell product
- Board team in place
- “World view” caveat

(f) “Gut-feel” Test. Does the business plan feel good overall? (What more to say?)

3. **Participation Structures**. Must it be another new series of preferred stock? What form of investment is needed in relation to those that are proposed? Equity participation has been the traditional model for VC groups, but it was never the exclusive structure. However, some form of convertible instrument is typically included so that an exit strategy is present if an IPO or acquisition is done. Other structures have included: alternative financing mechanisms, bridge loans, equity lines of credit, M&A structures, bankruptcy workouts, etc. The opportunities are open-ended.

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