Coutts

# *The price for growth*

THE VENTURE CAPITAL MINDSET:
WHAT YOU NEED TO KNOW TO SECURE AND SUCCEED WITH VENTURE CAPITAL

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# INTRODUCTION BY DYLAN WILLIAMS

Venture capital (VC) investment plays a critical role for entrepreneurs in the UK. Of all sources of capital, these investors are the ones who are most attuned to the entrepreneurial mindset of a business with great potential.

That is one view of how venture capital works to support growing businesses.

Another entirely different one is presented in the research we commissioned for this report. In asking entrepreneurs what they think about venture capital investors, how they work with businesses and what motivates them, we uncovered attitudes which show a gulf between VCs and the entrepreneurial community.

Yes, entrepreneurs believe wholeheartedly that this investment is likely to deliver growth. But that is not all. An increased risk of business failure, interference with management and concerns over the lack of alignment between the entrepreneurial mindset and that of the investor are all seen as part and parcel of the VC package.

What's more, these perceptions translate into the reality of working with venture capital. The majority of those with this experience say that although they did not regret working with venture capital, they could not say their investors were proactively supportive in problem solving or made an effort to fit in with their business and management team.

On a most simple level you could conclude that this represents a failure for venture capital investors. But the more important point drawn from this research is that the entrepreneur who needs this type of investment will face a substantial challenge in securing the right deal for their business and making the partnership work.

So what does it take to succeed? Talking to entrepreneurs and investors, it comes down to the ability to prepare with the right knowledge and mindset in approaching a deal.

And this is the focus of the report. Using the insight from entrepreneurs about what really matters in working with venture capital investors, we provide a blueprint for entrepreneurs considering VC investment to grow their business so they have the best chances of achieving the investment they want on the terms which work for them.

After all, as entrepreneurs acknowledge, venture capital investment remains a critical part of the funding mix available to businesses and one which no business should rule out.

Dylan Williams | *Managing Director, Coutts*

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# | 01 | VENTURE CAPITAL: WHAT ENTREPRENEURS REALLY THINK

*Venture capital and private equity may have firmly established themselves as drivers of business growth but many entrepreneurs are wary of the venture capital experience and the ability of investors to deliver sustainable business growth.*

Venture capital, it seems, is everywhere around us. At the big ticket end, private equity is rarely away from the business pages who track the success of big name investments like Alliance Boots the chemists and the AA. The mainstream media celebrates new and successful VC-backed companies like Glasses Direct and LOVEFiLM. Even the normally unseen world of early stage angel investment has been glamorised by the BBC's Dragons' Den.

Equity investment, in all of these guises, may be more visible than ever but, according to our research, entrepreneurs have a much more distant relationship with venture capital than the one portrayed by the media.

As we highlight in the key findings of our research (see box on page 7) a large majority of entrepreneurs are open to the idea of working with a venture capital investor – and many say they have considered it. However, scraping beneath the surface, the reality is that entrepreneurs are largely circumspect about what these investors offer and are sceptical about the outcomes from that type of investment.

This cuts across both groups of entrepreneurs we questioned for our research: those who have experience of venture capital and those who do not. But it is particularly the case with those who have not had experience of working with venture capital. This may not be wholly surprising: after all it is hard to build knowledge without first-hand experience. However, our research shows the implication of that lack of knowledge has a significant impact on entrepreneurs on three important levels:

- It creates an unwillingness to engage with venture capital as evidenced by the fact that only 10% say they would currently consider this funding route (compared to 20% of those who have had the experience of this investment). Entrepreneurs are three times more likely to choose a bank for growth finance
- The benefits of VC are the cause of deep scepticism: This is particularly seen in terms of risk sustainability of growth and the motives of the investors
- It drives misconceptions about what is important to succeed with a venture capital investor: Perceptions of the experience are out of sync with the reality of securing and working with a VC

So although some entrepreneurs are happy to recommend venture capital as a source of growth for others who need investment or consider it in the future for themselves, the over-riding sentiment is that "venture capital is not for me".

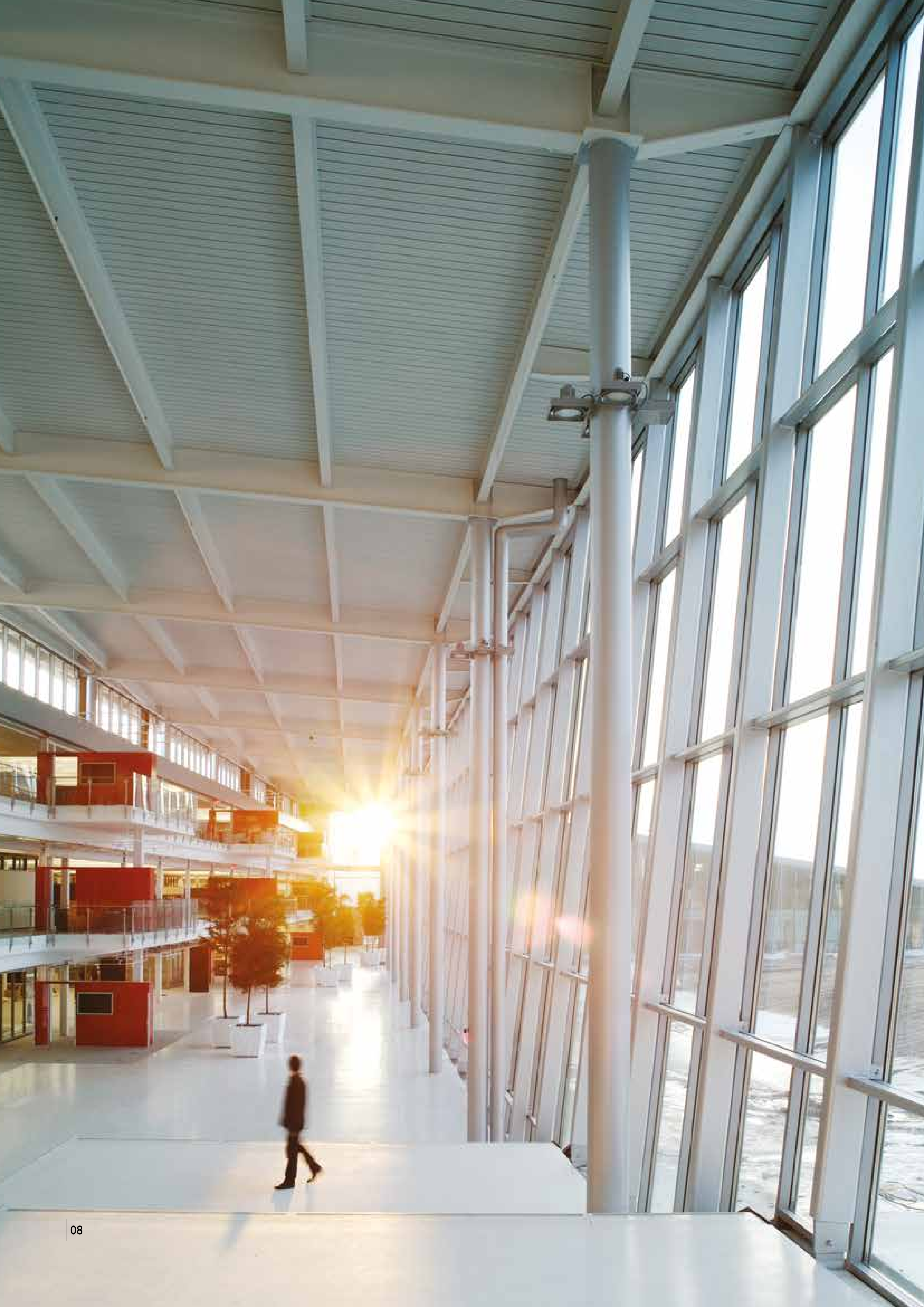
Bracketing all of this is what may be the root cause of this scepticism: The fact that entrepreneurs in the UK, both those with experience of VC and those with none, believe venture capital investors do not have a good reputation.

The key issue this raises is that many entrepreneurs may be laying aside an opportunity to explore a potential route for business growth due to misconceptions about this important source of investment. It also suggests that if they do decide to explore this route, they are likely to approach potential investors with the wrong mindset.

Using the findings of our research, the aim of this report is to help entrepreneurs make the best informed decisions about venture capital.

So in the sections that follow we use the experience and knowledge of those who are familiar with venture capital to give insight into what entrepreneurs need to know in order to get the "Venture Capital Mindset" and so maximise their chances of successfully working with this type of investment.

We address three key areas where this mindset can have the biggest impact and where our research has highlighted a lack of understanding among entrepreneurs: understanding how investors (VCs) think, getting the right deal and delivering success from the deal.



## RESEARCH SNAPSHOT: WHAT ENTREPRENEURS THINK ABOUT VENTURE CAPITAL

**Entrepreneurs are open to working with venture capital:** 81% of entrepreneurs would accept this investment in their own business; 80% would advise another entrepreneur to seek venture capital to grow their business.

**The majority are confident of securing investment:** 69% believe that they would get what they wanted from a VC although over half (56%) believe the experience will be enjoyable.

**Entrepreneurs strongly link venture capital with accelerated growth:** 69% believe a business with VC investment will grow faster.

**Venture capital is not seen as delivering sustainable business growth:** A minority (28%) of entrepreneurs believe venture capital offers the best way of achieving growth prospects for a business and even fewer (19%) believe venture capital-fuelled growth is sustainable. Despite this, 59% of entrepreneurs believe that without venture capital investment many businesses are unable to achieve their full potential.

**Entrepreneurs believe working with a VC increases the chance of business failure:** 24% think that VC increases the chance of business failure. A figure which is consistent among those with or without direct experience of venture capital.

**Few believe VCs to be better partners than banks:** 32% of entrepreneurs believe this to be the case. Although amongst those who have experience of venture capital, 39% are much more likely to agree while 25% tend not to agree with the above statement.

**Entrepreneurs indicate venture capital investors have a problem with their reputation:** Only 22% agree VCs have a good reputation while 37% of entrepreneurs think VCs are interested in entrepreneurs and understand their needs. Approximately 44% believe that a VC's main motive is a quick profit.

**There is a significant divide between the perceptions and reality of working with a VC:** Those who have worked with a VC believe more strongly that they are supportive of entrepreneurs (43%), fewer believe their motivation is a quick profit (35%) and more believe they are better partners than banks (39%).

## Venture capital or private equity?

One area of debate among entrepreneurs and investors in putting together this report was whether to use the phrase venture capital or private equity. Listening to the opinions of entrepreneurs we went with their views and chose venture capital.

# | 02 | THE VC MINDSET: UNDERSTANDING HOW INVESTORS THINK

*In a landscape where investor priorities change, entrepreneurs should do their own due diligence on potential venture capital investors as part of planning their funding needs and strive to create relationships with them.*

The first major area to get right when it comes to weighing up the potential offered by venture capital, is developing an understanding of the nature of venture capital investors and their mindset. And with so few entrepreneurs able to say they have a strong understanding of how VCs work (see box) it is a clear priority for anyone weighing up their funding options.

David Cleevely (pictured above) is an entrepreneur and leading technology investor in Cambridge. He has backed a number of companies from early to late stage investments. He says it is important for entrepreneurs to look beyond the headline-grabbing private equity deals and understand that in reality, seed and early stage investment by venture capital companies and angel investors are a vibrant and viable source of investment for business.

"The way money flows into business is not represented by the way it is lobbied or written about," says David.

Alex van Someren, an entrepreneur with experience of raising £14m of venture capital and now an early-stage technology investor, agrees. But he says that although the elision of debt-fuelled private equity and

**RESEARCH INSIGHT: KNOWLEDGE AND RELATIONSHIPS WITH VC**

**The majority of entrepreneurs say they do not have a strong understanding of venture capital and how it operates:** Only 33% say this is the case although amongst those who have had investment this rises to 53% and is as low as 18% for those who have not.

**Just under half of entrepreneurs believe that VCs are open and approachable:** Only 48% believe that VCs are open and approachable.

**Overall, a minority of entrepreneurs maintain relationships with VC sources:** This is higher among those with experience of VC (45%) but significantly lower (7%) among those who have no experience.

**Around half of entrepreneurs know the VC relevant in their sector:** 47% of entrepreneurs say this is the case.

**Half of entrepreneurs who have not worked with a VC have considered it:** 52% say they have never considered VC investment, 4% have been advised their business would not be appropriate for VC funding and 44% have considered an approach but never progressed it.

venture capital – traditionally the source of growth finance for businesses - has been unhelpful for entrepreneurs trying to understand the benefits of this source of finance, it is down to them to build their knowledge of sources of funds available and what they can do for their business.

"An entrepreneur who cannot work out the difference between angel, venture capital and private equity finance is unlikely to be a successful investment," says Alex.

So if knowledge and mindset are important, what are the key areas that entrepreneurs should know about when it comes to venture capital? As part of our research, Coutts put together a panel of sixteen entrepreneurs and investors experienced in venture capital and asked them. Here are their views:

### 1 Understand the equity gap

Venture capital is an expensive business. The fees required to do a deal and the cost of filtering and validating investments means that a typical firm will not look at a business which needs £500,000 to £2m in funding. There may be money elsewhere but entrepreneurs are likely to be wasting their time approaching VC for funding at this level. We highlight alternate channels in the final part of this report.

### 2 Appreciate the economics of a deal

If there is one metric from the VC world that entrepreneurs need to understand the IRR is the rate of return. This figure is the target return a VC investor will expect from an investment in your business and is normally significantly in excess of 20% per year of the money invested.

For your deal to work for a VC, you need to be able to deliver back that return over an agreed period of time. The bigger the risk, the higher the return.

### 3 Understand that the investors have investors

"Private equity and venture capital firms are themselves managing funds within strict predetermined investment guidelines," says Darren Jordan, Partner of independent private equity firm Silverfleet Capital. "Understand these and you will better understand the behaviour and investment motives of their potential investors."

### 4 Understand the different types of VC

"Different types of venture capital investors are right for different business in different sectors. And specialist investment firms can offer a great deal by way of skills, expertise and connections within an industry," says David Lester, MD of specialist SME publisher Crimson Publishing. First, understand the extent to which investment is available for a business in your sector and at your stage of growth. This is critical to understanding who might invest in your business and how much they will offer. Doing this due diligence will help you ask the right person at the right time for investment in the growth of your business.

### 5 Think beyond venture capital

Venture capital firms aren't the only people who will put money into your business. "It can be a real coup to bring in an industrial investor," says David Cleevely. As well as the venture capital arms of businesses, individuals within investment banks and even private offices of high-net worth individuals and families are all sources of potential investment.

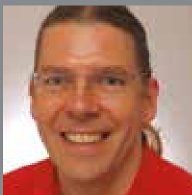
### 6 Get with the networks

Networking is the key to getting to people who may invest in your business. "They are critical," says David Cleevely. "This is because they validate the person and the business coming forward and set it apart from the man in the street."

### 7 Understand what makes a business investible

If you are going to invest your time in approaching venture capital firms then you need to maximise your chances of success. "Careful presentation is key because investors judge a range of factors. Your initial approach, the way you present your business, your management team, the money you want and your plans for using it, these are all part of the package which will influence the investor beyond purely the financials," says Daniel Domberger, a Director at corporate finance firm Livingstone Partners. "Take the time to understand how best to present all this to get the deal you want. And take some advice either from professionals or from others who have been there before."

## INVESTOR INSIGHT: CHOICE - TO GO DIRECT



**Alex van Someren has insight of what it takes to attract venture capital from the perspective of entrepreneur and investor. He is one of the team of investors at the Cambridge high-tech investment house Amadeus Capital Partners. As founder of IT security firm nCipher he raised £14m in venture capital before taking it to a stock exchange listing in 2000.**

"The priority for many venture capital investors is the team in the business, this is my priority when I am looking at an investment. First, I think about the people and whether they will achieve the impossible, then I am interested in the problem they are solving and the size of that market and then what is the technology. A lot of people think it is just about their exciting technology or solution and fail to pay sufficient attention to the quality and experience of the people. I won't invest in a solo entrepreneur as there is no such thing as one person business. I need to see that they are a leader capable of recruiting and developing other people and if they aren't smart enough to do that then they aren't right. An acceptance that you need to surround yourself with smart people is desperately important."

"When it comes to approaching investors, I want to invest in someone who has been referred, who I know and who I can trust. We have never ever invested in a business plan submitted through our website. I am ruthlessly difficult with intermediaries because I feel that if an entrepreneur can't get in front of me at seed stage they are probably not smart enough to be invested in."

## MAKING THE CHOICE

When it comes to comparing the perceptions of entrepreneurs about how best to approach venture capital investors and the advice from those who have experience of venture capital, one major area of difference is around the role of professional advisers.

The perception from those who have yet to raise finance is that going through a corporate financier is the best approach to take (44%). Those who have done so successfully rate a direct approach (43%) as the most favourable route to investors.

The answer is to make sure there is a balance. Investors appreciate an open discourse, particularly with experienced management teams but advisers play an important role in targeting the right investors and helping set the right parameters for discussion. Investors will come into their own as a deal progresses and are vital in getting you over the line with a deal that works for both investor and entrepreneur. However, they aren't the ones to sell your business for you – after all it is you the entrepreneur that they are backing and you will know the business best.

# | 03 | THE VC MINDSET: GETTING THE RIGHT DEAL

*You may need to raise money to grow but that doesn't mean that you have to accept money at any price from a VC. Taking control of the deal and being clear about what you really want from the investors can pave the way for success.*

Once you have made an informed decision that venture capital investment is the right route for your business, your second area of focus for entrepreneurs is to get the right mindset to deliver what the business needs. This means preparing yourself and your team for your dealings with investors and being clear in your mind about what is important to you and what is not, in a VC deal. It is critical to getting the deal which fits with you and your business.

According to David Lester, "An entrepreneur who takes time to establish what he or she wants from a deal will be better placed to stay in full control of the investment process. It also brings clarity about the things you are prepared to compromise on and factors that can be deal breakers."

**RESEARCH INSIGHT: ATTITUDES AND PRIORITIES IN DEALING WITH A VC**

| | What matters most when choosing a VC partner? | | |
|---|---|---|---|
| | | Those with experience of VCs | Those with no experience of VCs |
| 1 | Track record in my sector | 30% | 31% |
| 2 | Cultural fit | 22% | 15% |
| 3 | Quality of the VC team | 14% | 15% |
| 4 | Equity stake required from the VC | 13% | 16% |
| 5 | The level of control to be ceded | 13% | 22% |
| 6 | Amount of capital available | 7% | 4% |
| 7 | Has worked with someone I know | 1% | - |

| | What do you think about the process of raising venture capital? | | |
|---|---|---|---|
| | | Those with experience of VCs | Those with no experience of VCs |
| 1 | It is enjoyable | 40% | 3% |
| 2 | Not enjoyable (but necessary*) | 40% | 56%* |
| 3 | Time invested is seeking VC is worthwhile | 21% | 43 % |

While it is money that entrepreneurs seek from a venture capital investor, those who have experience of working with venture capital investment, say the qualities that matter most are all about the people you will be dealing with (see boxes). Track record, cultural fit with your business and the quality of the investment managers far outweigh the stake investors want in your business or the amount of money available.

But these aren't the only things that matter. Our panel told us that success requires two other factors: confidence and honesty from the entrepreneur leading the business, that a deal with a venture capital investor is really the right thing.

When bringing together the experience of entrepreneurs who have received venture capital investment and the advice from the panel, we found that five key areas of preparation emerge for any entrepreneur who plans to seek venture capital.

## Lesson one: **Be really honest about what you want**

Venture capital is not for everyone. Your business will be managed more robustly, you will be under pressure to deliver growth and according to Andrew Morris, who worked with venture capital backers on Earl's Court and Olympia, "As soon as you take the money you start running the business with a clock ticking in your head."

Brian Astley was one part of the two management buy-in team who bought the outdoor retailer Millets backed by venture capital investors in 1999. He says it is important to recognise that even if your growth prospects are promising it will not be right for everyone. "There is a 'Dragons' Den' culture where it has become fashionable to think about high growth and leveraging, when for many people it is not the right decision and it is perhaps wishful thinking that has persuaded them to think that they can deliver what a VC wants. A lot of people go into venture capital and don't think about how much money they really want to make or how quickly they want to make it. They then become victims of the venture capital process which doesn't work for anybody."

This echoes another entrepreneur we spoke to in our research:

"The aspirations of VC funders do not sit well with longer term business ventures. They are typically looking at a payback after 5 to 6 years. Most businesses need 10 to 15 years to meet the challenges of successful business development. The pressure applied by VCs for a prompt exit can take focus away from what should be the longer term aims and needs of a sound business. Applicants for VC often commit to unrealistic growth forecasts to achieve funding."

Stephen Thomas, the former Chief Executive and founder of night club operator Luminar agrees, "If you aren't honest about what you want, you will get led by the nose and do something you hate. I love my business and you have to go into business happy every day. To get VC investment and then hate going into work each day because of that must be the worst feeling in the world. One thing that is important is to remember that this is about you and you need to honest with yourself about what you want."

## Lesson two: **Be confident about what you want for your business**

The second clear message for entrepreneurs seeking venture capital is that confidence in your business and its future prospects plays a critical role in getting the right deal.

Although starting out with confidence that you will get the money you need is critical (a result which 69% of entrepreneurs said they would achieve), there is a distinct difference between being offered the money and getting the deal that is right for your business.

"An entrepreneur needs to be firm and clear in fundraising about what is acceptable. In my opinion they shouldn't be prepared to sign up to differentiated shares which favour one investor, onerous monitoring obligations or the imposition of directors," says Alex van Someren. "A smart investor will not bring those things and an entrepreneur should stand their ground and be prepared to walk away if the deal isn't right. I did this with the venture capital I raised for my business in 1998. We told investors that ours was a high quality business and that for you to invest you need to accept the terms available to everyone else."

According to David Cleevely, "Although the funding environment today may be different, the importance for the entrepreneur taking a lead and setting a tone for the deal remains the same."

So while the money may be forthcoming, the entrepreneur should always reserve the option of walking away, which, within our research findings, around 12% of those who had approached a VC said they had done.

### Lesson three:
### **Don't compromise on quality**

According to the panel, entrepreneurs are right to put track record at the top of the list of priorities for any venture capital team they plan to work with. Although the type of businesses the VC may have invested in before and their ability to demonstrate success in the sector is important, what really matters is the quality and calibre of the team that will be working with the entrepreneur.

Jim Heathcote is an entrepreneur and investor based in Cambridge who has successfully raised venture capital before. His advice is that entrepreneurs should be clear that this quality is not a given.

"You shouldn't go to a VC looking for money, you should go to them to see if they are any good. What you want is smart people, there aren't many out there and the ones that are can be hard to find," he says. "I believe you should look beyond the money at what they will bring because what you need is people who are a good enough calibre to support the business and take it forward. From my experience only a very small percentage of people fit the bill and it is really important for you to look at the money and the people to help your business get through the growth successfully."

The message from those who have worked with venture capital is that, the money is not enough, it is the people who count and this should dictate whether you take any money that you are offered.

### Lesson four:
### **Make sure the culture is right**

When it comes to making an investment work, the extent to which

the culture of your business and the culture of the investor work together, are most likely to define eventual success of the deal or otherwise. Those who have worked with venture capital rate it as the most important success factor, after factors such as track record of the team. The advice to entrepreneurs who plan to seek venture capital is to make sure this fit is right.

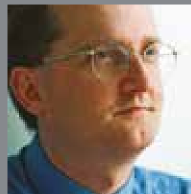
"The entrepreneur needs to find someone who is entrepreneurial. If you can find an investor who is entrepreneurial you have a much stronger chance of having a meaningful business engagement with them because they have a clue about what you are talking about and understand the nature of the slings and arrows you will face," says Alex van Someren.

"One of the things I am very uncomfortable about in investment is dealing with people who only have financial backgrounds and have never had operational backgrounds because they make decisions which are inadequately grounded in reality. I don't think jockeying spreadsheets is an adequate way of making decisions about how to run a business."

John Heathcote, a Cambridge based entrepreneur and investor agrees. He says, "The wrong culture among your investors can prevent success and jeopardise future growth."

"You have to beware of the bean counter who has no knowledge of

## ENTREPRENEUR INSIGHT: THE FUNDRAISING MINDSET



**Glenn Collinson is the founder of Cambridge Silicon Radio (CSR) a chip company which he co-founded and grew with the support of venture capital before floating it in 2004 with a market capitalisation of $3bn. He has recently started a new venture and raised venture capital for a second time.**

"The first time I raised venture capital, I had a very positive experience from beginning to end. That experience in raising money and exiting is why we have done it a second time. Our thinking is very much about thinking big, taking a smaller piece of a bigger pie, having a global vision. We went out with that plan and tried to raise $10m in September 2010. It was much harder than back in 1998: I'd say it was too hard this time too easy the last. We were fortunate, we visited 35 VCs in 9 months all in Europe and got 34 'no's' and one 'yes', because we work in a very narrow sector which is relatively small in Europe. It was a vibrant sector in the 1990s for investment but is totally different now. In fact for companies that were funded in the 1990s such as CSR it would be virtually impossible today in the UK. It was only because we had a different business model this time and a track record that we got a 'yes'.

For CSR the first investment in 1998 was $10m which we then built to an IPO in 2004. Through that time we raised $85m in total from eight or nine investors including the corporate arms of large companies. My type of business had a well-established precedent that it takes $50-100m to get to breakeven and we couldn't have done that without the investment. To get corporate money we went through an investment bank and wouldn't have got it without them. We had a big roadshow (our investment bank ran this) and their input was invaluable.

I had a 3% stake in the business but I felt like I owned it and I lived and breathed it. In total the management had about 9-10%. A mentality of not hanging on for control is really important. So too is working out where you can get money from. You need to have a good look around, get the intelligence and see if there is venture capital out there for a business like yours."

### ENTREPRENEUR INSIGHT: THE CHOICE TO WORK WITH VC REQUIRES HONESTY WITH YOURSELF

**Brian Astley was one of a two man management buy-in team which led the growth of Millets for four years from 1999-2002 backed by venture capital. Despite this success, in running his current business he is more circumspect about bringing in venture capital.**

"I think an important piece of advice for business owners is to understand that venture capital is not the only way to deliver business growth. I own a small business now where at some point in the future we could possibly think about going for outside venture capital but I'm not sure we will end up going down this route.

Because I have made some money previously my personal appetite to make much more money may be less than others. I like that I am pretty much in control of what I do and I don't really want someone else in there who may have a different agenda than me at certain points in the company's development. Within reason, if that means I make less money or I make the same money more slowly, that's probably fine by me. There are a lot of people who go into venture capital who don't think about this and become victims of the process and it doesn't work for anybody.

It is important to remain open-minded and to stay in control. I might go back to venture capital investors if there was an opportunity for really fast growth which could only be achieved by external financing. But I probably wouldn't stay around in the business for long. I am not against the idea of venture capital at all but if I can grow the business reasonably quickly and without external finance I would probably choose that path."

the business. The people you want around your business and on your board are entrepreneurs.
It is desperately important you have like-minded people. Innovation is a desperately fragile thing and you don't want overbearing financial analysis getting in the way of making the leaps forward which are hard enough on their own. Financiers can be incredibly destructive. My advice would be to spend time and effort bringing in entrepreneurial people."

While it is difficult to do due diligence on an entrepreneurial skill-set or the strength of their networks pre-deal, it is possible to establish whether the background of the team is purely financial or whether they have operational business experience. This will give an appreciation of the challenges you will face.

### Lesson five: **Don't be hung up on control**

For entrepreneurs who have never done business with a VC, once they are satisfied with the track record of the people they will be dealing with, the issue of control of the business, and the amount they give away in the investment process concern them the most. While the issue of control is important, it is one which requires fundamental reappraisal for any entrepreneur who wants to secure venture capital.

Glenn Collinson was the founder of Cambridge Silicon Radio and has just raised a new round of venture capital for a new business. "The most important mentality is not one which hangs onto control but one which is focused on ambition," he explains.

"Venture capital investment is about the opportunity to have a small part of a larger pie. That should be the starting point for an entrepreneur and they must possess the mentality of thinking big. If the entrepreneur can't appreciate that they shouldn't bother with this type of funding."

Stephen Thomas is equally unequivocal in his advice, "If you feel that your business has the chance to really take off and that it is VC investment that will get you there then you have to be prepared to live with the investors and give away some of the business you have grown. This may be hard for a business you have birthed and nurtured but if you want VC money you have to live with them and entrepreneurs are wrong to perceive that as being ripped off."

### HOW TO SECURE THE DEAL YOU WANT FROM A VC

Be honest about what you want: Be really clear that venture capital funding is right for you and your business.

Be clear about the deal you want: Prioritise what matters most and what you are prepared to compromise on to stay in control of the deal and to get what works for your business.

Focus on quality: A good deal will bring in venture capital money and skills; not everyone will be able to deliver what your business needs.

Look for entrepreneurial spirit: You need empathy from your investors if your business is to thrive.

Think about opportunity, not control: Make the shift from founder and owner manager to shareholder; think about the potential reward you will get from a more valuable business not how much you own.

# | 04 | THE VC MINDSET: DELIVERING SUCCESS FROM THE DEAL

*The relationship with a VC is one that requires proactive and skilled management from an entrepreneur. Being clear about the boundaries, targets and control upfront is what frees you to concentrate on growth and success.*

Of all the areas of venture capital process the mechanics of the VC-entrepreneur relationship is the area that, once in a deal, you simply can't afford to get wrong. But because relatively few businesses receive venture capital it is also the area that is poorly understood by those who have not had experience of VC investment.

"This is in part," says Alex van Someren, "because bad stories about venture capital tend to carry more weight than the good ones."

But, as David Cleevely says, "There should be no misunderstanding that it is fundamentally important to align everyone's interests; the business, the investors and the entrepreneur must all have incentives pointing in the same direction."

**RESEARCH INSIGHT: WHAT TO PRIORITISE WHEN RUNNING A VC BACKED BUSINESS**

| | What is most important when working with a VC? | Those with experience of VCs | Those with no experience of VCs |
|---|---|---|---|
| 1 | Ensuring chemistry between investor and management team | 25% | 18% |
| 2 | Ensuring growth and financial targets met | 24% | 19% |
| 3 | Retaining control of management team | 19% | 10% |
| 4 | Effective expectation management | 10% | 18% |
| 5 | Understanding investor needs | 7% | 10% |
| 6 | Standing your ground on key issues | 5% | 10% |
| 7 | Committing to a fixed exit and vision | 4% | 10% |

| | Which of these is true when you work with a VC? | Those with experience of VCs | Those with no experience of VCs |
|---|---|---|---|
| 1 | You lose control of the business | 37% | 46% |
| 2 | The business is managed more robustly | 61% | 45% |

Making the most of this alignment of interest, according to our panel, is a critical area where entrepreneurs need to have a clear agenda and set expectations on both sides from the outset. Here the panel share their insight into what makes for a successful relationship so you can ensure you remain in control.

### 1 **Set the tone from the start and you will avoid VC interference**

A major concern for a significant majority (57%) of entrepreneurs is that venture capital inevitably brings interference in the business you are trying to run.

The reality is that although venture capital investment means a business will be managed more robustly (61% with experience say this is the case) this does not mean an entrepreneur should accept interference. In fact those with experience of working with VC investors say that it is less likely that you will lose control of your business as a result of the deal.

Making the relationship work, says Andrew Morris, is down to setting the tone from the start with your VC team: "The issue is to set the boundaries really early on. You are running the business, they are investors and experts in finance. They are excellent at what they do and you have to be pretty tough with them and tell them there is a line you do not cross right from the beginning and be prepared to stand your ground. If you understand that and they understand that, it is a great relationship."

Part of this, he adds, is about being clear about your strategy post-investment: "It may seem obvious but you really need to think about how you are going to grow the business, how you are going to exit and how you are going to increase the multiple for your investors. There is a danger with entrepreneurs who have run a business which is lean and mean, where they have access to cash, they feel the need to spend money and hence blow the opportunity."

The message for entrepreneurs is clear; taking charge of the relationship early and demonstrating your vision for the business to your investors is the best way of giving them the confidence to leave you to run the business.

### 2 **Keep control of your Board**

A second area which entrepreneurs highlight as critical for working with venture capital investors is that of control over the Board.

While venture capital investors may insist on taking positions on the Board, it is critical to resist excess control and for the management team to be left alone to set the strategy for the business, according to the Coutts Panel.

"If you have a situation where they provide the chairman and the non-exec they are effectively setting the direction of the business and you are in trouble," says John Heathcote. "Your business will go in the direction that your funder-in-chief wants it to go."

Stephen Thomas agrees, "The entrepreneur needs to landscape the Board for the benefit of the business and not the investor," he says. "If you get into a situation where they are putting people into Board positions and if this extends to influence over areas such as the finances then that is the start of a loss of control and you are the one who will get slapped in the face."

"I know some businesses who are suffocated by non-execs that are appointed by a non-exec chairman who is there to protect the interests of venture capital investors and he is seen very much as part of their team and not part of the management team. The Board structure is a really critical part of the chemistry between VC and entrepreneur and one you have to get right."

Making the relationship work, according to Glenn Collinson, means being clear with your investors that their role should be a background one, not one of dictating strategy or chairing the Board.

### 3 Surround yourself by a great team

For most entrepreneurs, leading a successful VC-backed business means learning to lead the business in a different way. The skill which is key to success, says Alex van Someren, is to surround oneself by people who have the experience you need. "Looking back at my success, I was a lucky amateur building and selling the business surrounded by great people and experience."

It is not surprising then, that entrepreneurs who have experience of investment say keeping the ability to shape their management team is one of their key priorities – an area which our research shows is less important to those who have not had VC investment.

Being able to bring the right team, says Stephen Thomas, is about being honest with regards to the areas where you need help.

"I found that the things in my business which I was really good at were not necessarily the things investors expected of me or wanted me to do. The first thing I learnt in dealing with venture capital was the importance of being streetwise about how I managed those areas and learnt that letting someone step over me to deal with them for me was the right thing to do."

Andrew Morris says it is critical that the entrepreneur takes a lead in this. "If you demonstrate that you have the best management team for the business then the VC will understand this, back off and support you when necessary. If your management team is flaky you can expect the VC to ask you to improve."

### 4 Be a master of expectation management

Entrepreneurs agree that a fourth priority area to get right in the VC-entrepreneur relationship is that of setting and meeting your targets. But a more important skill for driving the relationship successfully, according to the Coutts Panel is that of expectation management.

"The experience of running a business within a VC relationship is no different to when you are outside of one. It is rarely plain sailing and there will be set backs along the way. So how you deal with that becomes very important," says Andrew Morris.

### ENTREPRENEUR INSIGHT: HOW TO WORK WITH A VC

**Andrew Morris worked with venture capital backers when he bought and grew London's Olympia Exhibition Hall and says this investment and the strengths of his investors were critical to success.**

"For me venture capital was a step into the unknown but I couldn't fault my experience with venture capital from beginning to end. The thing that really stood out for me was that running a business with VC investment was like driving a business with a clock in your head. You are aware that the pressure of the internal rate of return you need to generate, the ticking of time and the drive to exit. These were compelling. I was in the business for four and a half years and I found the discipline excellent.

My investors never tried to meddle with the management of the business and were excellent financial analysts. They may get a bad press in some areas, such as people skills, but really it is for the entrepreneur to manage the impact of VC on a business. If you don't want to come out very burnt you have to set boundaries and be resolute about your conviction in running your organisation in the way you believe will deliver growth.

I was very conscious of the Board dynamic so one of the things we resisted was the imposition of too many people on the Board. We had an equal selection of the non-exec chairman so we both had to be happy with that appointment. The result worked out well and we also only allowed one Non-exec Director from the VC where they wanted three as I saw the make of the Board like that as really unhealthy. By stating my conditions, it allowed the management to lead the strategy and running of the business.

It is important to remember at all times that fundamentally you are both completely aligned. I have to say that I had some very bumpy setbacks and they took it really well and didn't get fazed. Even during the exit there were some setbacks and they took it on the chin and were there for us in the legal stage that you have to go through and held our hand very firmly. I know of no other way of making a really major capital gain than going down that route."

"My rules were that if there was bad news I would tell my investors early and exaggerate it, and if there was good news I would wait until I had signed the deal. Managing the expectations of the budget is critically important."

### 5 The extent to which the VC relationship works is down to you the entrepreneur

The last critical issue for entrepreneurs is the thread which ties together all of the advice from the panel of entrepreneurs and investors we spoke to for this research. That is when entrepreneurs work with venture capital they tend to get the investors and the relationship they deserve. It is something they have a responsibility for shaping, starting with the selection of investment partner right the way through the deal.

"For me the relationship with venture capital is straightforward," says Stephen Thomas. "You have a business, you need money to grow it, you take it from a VC and then you have to perform. You have every opportunity before the deal to do the due diligence and make sure you are getting the right investment. Then it is down to you to manage the relationship and make it work. My only experience of a VC deal which has ended up with difficulty is where the management hasn't stood up for itself or it hasn't performed. And if you don't stand up to VCs or you don't perform you have to expect that things will get difficult."

As Andrew Morris points out in his insight 'How to work with a VC' entrepreneurs need to be prepared for a tough ride when it comes to working with a VC. Those that get through it successfully are the ones who are able to see the VC as a partner who is aligned to the business, be prepared for them to get more involved when things go off track and take charge of working through the issues. This will keep the relationship healthy and on track.

### ENTREPRENEUR INSIGHT: THE IMPORTANCE OF SETTING THE AGENDA WITH YOUR VC

**Barry Van Danzig was the founder and Chief Executive of Wastpack. He sold a majority stake in the business to venture capital as part of his exit from the business but found that a poor alignment between his investors plans and the needs of the business made for a tough experience.**

"When my VC came in and bought 51% of the equity the goal was to grow it and then sell. That was the defined objective. I had no problem with letting the VC into the business as owner manager because there is little attachment to waste, even though it was a great business which I loved. The only problem I had was the VC would say one thing and then do another. Although we started off with a shared vision they changed the rule book as soon as they could and the result was that they literally wrecked the business.

It was a very short space of time in between them saying 'we don't want to interfere, you know exactly what you are doing' to suggesting we needed a new FD. That was the first thing. They didn't know how to run the business and told me originally they did not want to take over managerially because they didn't understand it, but again, in the end they did exactly that.

If there is one thing that is really important for an entrepreneur to understand it is that a VC is not the person who should run your business. They are unlikely to understand the important detail of how it works. My business was with the VC for 10 years and I bought it back eventually as they ended up literally wrecking the business having run it their way.

Looking back I wouldn't change my decision to work with a VC but what I have learnt is that you can't do enough to make sure that you and your investors are on the same page, that they are honest about what they are doing. You can't start off with a shared vision and then change the rule book because trust is critical to success."

# | 05 | OTHER WAYS OF FUNDING YOUR BUSINESS

*Venture capital firms aren't the only sources of growth finance. Smart entrepreneurs will investigate networks, investment syndicates, government schemes, and new online crowdsourcing platforms as a source of equity.*

While venture capital firms are a dominant source of equity finance for businesses, they are not the only vehicle for entrepreneurs to raise capital when growing a business.

Richard Green is one entrepreneur who has chosen not to go down that route. In the 1990s he successfully founded Smallworld, a business which he grew and listed on the Nasdaq Stock Exchange. In his latest venture, Ubisense, he has successfully grown a £25m turnover business with an excess of £7m of investment, all without a penny from venture capital firms.

"When I started my business I spent time seeing hundreds of investors but it was a dreadful experience and on the strength of that we decided not to go that way. I have never been able to find the quality to go with the money," he says. "If I am honest, we went through the motions because we wanted to see what was out there but we had a feeling that it wasn't going to work."

Such a long shareholder list may appear to bring its own complications but he says this is not an issue at all for the business, "Our investors are serial entrepreneurs and we have no problem dealing with them."

Stephen Thomas is another entrepreneur who shares his recent experience of bringing in investment in this way and says that new direct funding models allow entrepreneurs to do that more simply and benefit from stronger links with successful business people.

"We worked through Rockpool who have access to 1,000 entrepreneurs. They arranged a lunch to present to their investors and we raised £7m investment in that lunchtime. It was an amazing experience," he says. "Working this way is great. We have 72 wealthy individuals on our shareholder list, we meet them and they use our products. I really think this is the way forward for a deal in this region because you create a business where you are connected to shareholders."

According to David Cleevely, it is important for any entrepreneur seeking investment at this level to understand both the availability and magnitude of finance available through networks which fall outside of the traditional VC model.

## SYNDICATE INVESTMENT, CROWD FUNDING AND THE BUSINESS GROWTH FUND

The three main alternatives to raising venture capital are through firms who manage investment syndicates, crowd funding platforms and the Business Growth Fund.

**Investment syndicates** are a well-established alternative to venture capital and tend to focus on investing in the region of £1m to £7m in growth businesses. Rather than managing the funds of institutional investors the capital they invest comes from high-net worth individuals who contribute tranches of capital to an investment. The investors will typically be experienced business people who can bring the benefit of their networks and advice to the business. It is in effect a middle ground between angel investment and venture capital. Firms active in this area include Connection Capital, Rockpool and FIG who bring together investors and screen potential investments for them.

**Crowdfunding** is a new and emerging route to finance for growth businesses and offers a route to finance from £10,000 to £1m. Online platforms allow businesses to register, present an online pitch for their business to the public at large and offer equity in that business in return for investment. The majority of investments fall in the range of between £10 and £5,000 which in aggregate deliver the amount of capital needed by the business. Crowdcube is the leading platform and has raised £2.5m in 14 pitches in the last year.

**The Business Growth Fund** is a new mainstream source of funding backed with £2.5bn of capital from UK banks. Its focus is in providing long term capital to support fast-growth companies. BGF launched in February 2011 and invests between £2-10m in return for a minimum 10% equity stake and a seat on the board. It has made four investments so far totalling £22.5m.

"It may be hard to reach angel investors with your proposition but online platforms where entrepreneurs can crowdsource their funding are increasingly offering viable alternative routes to equity investment which should be considered as part of the finance mix for entrepreneurs," says David Lester.

For entrepreneurs averse to venture capital and those who still want to raise funds for growth, these represent important channels for investment.

## RESEARCH INSIGHT: PREFERRED FUNDING CHANNELS FOR ENTREPRENEURS

If you were to consider additional funding to grow your business today which would be your preferred source?

| | Those with experience of VCs | Those with no experience of VCs |
|---|---|---|
| Cash flow/profit | 32% | 31% |
| VC | 20% | 10% |
| Bank | 15% | 35% |
| Friends and family | 13% | 10% |
| Angel | 11% | 8% |
| Invoice/asset finance | 5% | 4% |
| Market listing | 3% | 3% |
| Other | 1% | 1% |

## Methodology

The contents of this report are based on research conducted on behalf of Coutts by Native Consultancy.

The research consisted of three phases:

- Qualitative research from two separate focus group discussions among entrepreneurs and investors who had experience of venture capital
- Quantitative research from a randomly selected sample of entrepreneurs consisting of 244 respondents
- In-depth interviews with 12 individuals with direct experience of raising venture capital based on the findings of the research

The research was completed in March 2012.

To find out more please contact your Wealth Manager or Private Banker.

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COU91474 (02/16)