The State of the Venture Capital Market in 2019

Discover how to position your business for Venture Capital Funding Success in 2019

John B D Colley

Publication arising from event held at Simons Muirhead & Burton, Solicitors, in April 2019

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Foreword

I was fortunate to be invited to an investment breakfast hosted by leading London Technology lawyer Simon Halberstam. Simon is a Partner and the Head of Technology Law at Simons Muirhead & Burton.

What follows is a summary of what I learned from the panel discussion. The summary reflects my personal understanding of the discussion and not the views of the panellists.

About Simon Halberstam and Simons Muirhead & Burton

Simon Halberstam was admitted in 1988, became a specialist IT Lawyer in 1991, and and focuses exclusively on Intellectual Property and IT/e-commerce law.

He is recommended in Legal500 for his expertise in Commercial Contracts. His department comprises Simon and 4 assistants, all focused on various aspects of technology law notably Commercial Contracts, Corporate Legal Issues and Intellectual Property.

The firm acts for over 100 technology SMEs and is very well versed in all legal aspects of fund raising. It prides itself on its expertise in this area and in providing a highly efficient, very transparent and inexpensive legal service.

For further information on the legal issues relating to funding, please contact Simon Halberstam at simon.halberstam@smab.co.uk

For more information on the legal services that Simon's firm provides to tech companies, please see www.weblaw.co.uk

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Introduction

An expert panel debated the state of the Venture Capital market for early stage, Series A and Series B funding in 2019.

This training summarises many of the key points discussed at the investment seminar and I have included my own views, comments and opinions based on 30 years of investment banking experience, 20 of them spent advising technology companies.

This training is important if you are an entrepreneur or founder who is looking to raise capital from VCs in the foreseeable future. As we discuss the key questions, the information will help you to position your company for funding and avoid many common mistakes and errors.

This easy to follow training addresses key questions that you are almost certainly asking already and provides clear guidance and answers that I am confident will contribute to making your next funding even more successful.

These are the key questions that were discussed by the panel of experts during the seminar.

1. **The State Of The Market In 2019**
2. **What Can We Say About Valuations In 2019?**
3. **How Do You Select VCs?**
4. **What Are VCs Looking For?**
5. **How Much Money Should I Try To Raise?**
6. **How Long Does The Investment Process Take?**
7. **When Is Debt Suitable For A Growing Business?**
8. **How Should A Founder Think About The Mix Of Debt And Equity?**
9. **What Documentation Do You Need?**
10. **How Should A Founder Sell To An Investor?**
11. **What Is The Deal Process From Signed Term Sheet To Cash In The Bank ?**

I hope you enjoy this training as we work through it together I f you have any questions, please reach out to me – john@jbdcolley.com and don't forget to check out my other Corporate Finance and Capital Raising courses (see the list at the end of this eBook).

The State Of The VC Market In 2019

Why is this Important?

Founders need to understand the major trends driving the funding market if they are to be successful in positioning their businesses for funding in 2019.

The 2019 Venture Capital market has seen fewer deals completed but those that are successfully closing have been larger and at higher valuations.

What does this tell us about the market? Despite there being no shortage of money looking for investments, VCs remain risk averse and prefer post revenue deals at higher valuations to earlier, pre-revenue investments which are by their stage of maturity higher risk. This indicates that investors are keen to see at least proof of concept and some customer conversion before getting off the fence.

The changes to the VCT rules a couple of years ago mean that this money is more tightly focus on real growth investment rather than secondary transactions such as buyouts. This has done nothing to address the appetite for risk that these funds prefer to mitigate by investing at later stages.

Sources of capital include corporates who are setting up venture funds which compete with the more traditional institutional investment funds. The corporates often try to offer strategic advantages rather than simply financial ones but this can lead to exclusivity clauses and conflicts of interest further down the road. Corporate funds are now seen to be involved in approximately 20% of deals.

The market is chasing quality and the competition for the best investments is driving valuations higher, particularly at the Series A and B investment stages.

Another interesting development is the emergence of tightly focused micro VCs which might prove to be a useful source of earlier stage funding going forward. They have the opportunity to fill the funding gap left by more traditional VCs moving away from pre- revenue opportunities.

What Can We Say About Valuations In 2019?

Why is this Important?

Founders need to take a realistic approach to company valuation and understand the risks associated with over valuing their business in a strong market.

Right now valuations are very attractive with the weight of money and the competition for the best deals being the two main driving forces.

It is true to say that VC investors prefer to invest in a quality company at a higher valuation than a mediocre one at a lower valuation. In simple terms, with more money chasing these deals valuations are going up.

There is a risk here and it's important that entrepreneurs are honest with themselves about valuations as this can come back to bite them in the next funding round. An unsustainable valuation in a series A can make a Series B round difficult or impossible to raise without the company accepting a lower valuation, leading to a "down" round in industry parlance. This can lead to all sorts of difficulties reconciling the interests of the existing and new investors.

Bear in mind too that investors are still looking for a meaningful stake of 20 to 30 per cent in your business. They may also protect themselves by structuring the deal with loan notes or a preference share to give themselves downside protection so it's not all about the valuation itself. These can protect their returns but only at the expense of the management and existing investors.

It is true to say that for a pre revenue startup capital remains very difficult to raise and entrepreneurs should not assume that VCs are the answer. Other sources of capital include family offices, high net worth individuals and Angel investors. Some accelerator programmes offer small amounts of start up capital. It is worth looking at Government grants across Europe as well. Another option is bootstrapping, easier to say than do and trying to raise your initial capital from your first customer in return for preferential terms and a special long term relationship.

Venture debt should be seen as complimentary and not an alternative to equity funding and is normally only available for post revenue businesses. It can help to mitigate the effects of dilution from a VC round but typically will not comprise more than 30% of the funding.

How Do You Select VCs?

Why is this Important?

Selecting the right VC is critical, not only to the success of your funding but also to the longer term relationship with your investors going forward.

Some of the key factors include the size of the round, the quantum of money being raised. Advisers will also look at the sector and specialisation of the company and try to match it with investors who have experience in that market.

It is true to say that advisers have their strong relationships with some VCs and will show them all their deals as well as try to identify the specialists who best suit the company

Beware of approaching a VC who has invested in a competing company. They will take the meeting but be on a fishing trip for useful information rather than seeing it as an investment opportunity.

Investors with funds also have an investment cycle of their own and you need to be confident that the investor you are meeting has the financial capacity within their fund for this round and potentially future rounds too.

At Series A and B geography plays a part too. It is fair to say that unless your company is very specialised, you should seek to attract investors from the same country that your business operates in. If you go abroad, one of the first questions you may be asked is why wont your local investors support your company?

What Are VCs Looking For?

Why is this Important?

When presenting your business for investment it is vital to understand the criteria on which you will be judged and the investment decision made.

Early stage deals still very much focus on the founder and entrepreneur. The investors are backing the vision and execution skills of the management team and particularly the leader of that team.

Can they sell their investment to investors and can they sell their companies products and services to customers?

Series A deals are more complex. Here the focus is on customer traction and scalability. It is worth reflecting that the range of series A deals is broadening, with some still very early and occasionally pre- revenue through to later more mature post revenue deals. The investment case remains dependent on the opportunity and business.

Series B deals are more clear cut and focus primarily on revenue traction and scalability.

Seed capital is very difficult but not impossible to raise from VCs but it's fair to say that at this stage investors are hyper selective and looking only for the very highest quality opportunities.

This is very much about backing an experienced team or a successful serial entrepreneur.

VCs will also be positively inclined to invest in a founder that they have successfully supported before or in a sector or sub sector where they have seen successful returns in the past.

Other sources of capital for pre-revenue deals remain friends and family, Angel investors, peer to peer lending platforms and crowd funding.

Investors also like to see defensible intellectual property, IP, preferably with some patent protection. A risk with patent applications is that you have to set out much of your competitive information in the patent applications and need to be able to afford to defend them, in court if necessary. For early stage businesses staying under the radar and not applying for patents is often the right strategy to protect their IP.

How Much Money Should I Try To Raise?

Why is this Important?

This will help you to focus on how to raise the right amount of money for your business not the maximum amount.

This is a key question.

Should I raise more than I need in this round, at a lower valuation to reduce the risk of running out of money? Or raise what I need and wait for the next funding round to raise more?

The best advice is more often to raise what your plan and your business needs. Focus then on running your business and delivering the milestones set out in your plan. Do bear in mind however that some investors have ideal investment amounts which may mean that either you have to raise more than you need or perhaps they are the wrong investor for your business.

Do not rule out the “do nothing” scenario. If you can get away with not raising capital from VCs then consider this seriously. Once you accept VC investment the dynamics of your business will never be the same.

How Long Does The Investment Process Take?

Why is this Important?

Entrepreneurs need to understand that the investment process is a marathon and not a sprint, but the time taken can be optimised with good planning and preparation.

The first stage of pitching and negotiating term sheets can take 2 months. At this point you are in the driving seat and are selecting between potential investors. Ideally this is a time when you can negotiate the best terms based on the competitive tension and from which you can select your preferred investors.

Once the term sheets are signed, investors will normally ask for 12 weeks to complete the due diligence and documentation process. If you can, restrict this time window - Offer 8 weeks but be prepared to accept 10 weeks.

In total the investment process can take 6 months, less perhaps if you already know the VCs.

When Is Debt Suitable For A Growing Business?

Why Is This Important?

Venture Debt is not suitable for every company and although it has benefits, founders also need to be aware of some of the potential issues and drawbacks involved.

Debt can be used to bridge a gap between funding rounds but this is not the best time to raise money. The best time to raise is when you are most liquid. During or shortly after a funding round. This works best from Series A onwards. Large seed rounds can be considered but these are the exception not the rule.

Debt can be used to extend your cash runway when you raise money. Debt providers align themselves very closely with the equity investors and will work with the same due diligence material, business plans and forecasts.

One of the advantages of venture debt is that you can extend the time between fund raising and give yourself more time to meet your critical business milestones.

The providers of venture debt will look very closely at the quality of the company's equity investors both existing and new and whether the existing investors are investing in the new round, following their money.

By their nature early stage companies have few assets and often no profits so there is little spare cash flow to service debt. The presence of institutional investors who take a more structured approach to investing and who are more likely to support the company in future rounds is an important factor for venture debt providers. Broadly speaking they will not feel the same confidence in high net worth investors.

Venture debt providers are also very sensitive to how existing investors have behaved or are likely to behave if things do not go well and the company fails to meet some or all of its milestones. Investors are always trying to anticipate downside risk.

It is worth noting that venture debt normally seeks to be paid down or refinanced at the next funding round and this must be taken into consideration when thinking about whether to take on debt and if so how much.

How Should A Founder Think About The Mix Of Debt And Equity?

Why Is This Important?

The worst thing that a company can do is over leverage itself. This will make financial performance between rounds more difficult and can compromise the next funding round.

This can vary from business to business. A good rule of thumb is 20% to 30% of the round. Venture debt providers will consider the extent of revenue traction to be a critical factor when evaluating a business.

The debt providers will not want to over leverage the company ahead of the next round but entrepreneurs should be aware that there are a range of different venture debt providers and their structures and investment criteria will vary.

Too much debt can damage the funding in the next round if a significant proportion of the new funds are needed to pay down the old debt finance. It is often better to start off with a smaller debt facility and in the next round refinance to a larger facility, following a larger funding round.

One way to manage this risk is to make the provision of the debt available only in tranches, measured against successful delivery of agreed milestones. These might include market traction metrics or the number of customer contracts for example.

What Documentation Do You Need?

Why is this Important?

Well prepared documentation is key to a successful and smooth fund raising process. Prepare your documents well in advance, particularly the complex data room documentation.

For the first stage of the investment process a financial model, pitch deck and one page summary will suffice. These will still take time to prepare and the management team must be able to talk to these in detail and defend the assumptions made in them.

The pitch deck should comprise between 8 and 20 slides and take no more than 20 minutes to deliver.

Once the raise gets beyond the heads of terms stage more complete documentation will be needed for the due diligence phase and this should be presented in a data room.

This information should include, historical and forecast financial information, a detailed Cap table, an organisation chart, existing equity documentation, shareholders agreements if they exist, the memorandum and articles of the company, employment agreements, customer agreements and contracts.

In other words, a full range of the financial and legal documentation of the company will be required.

It is a good idea to put the data room together ahead of time as this can be a time consuming process. Bear in mind that due diligence is about finding errors and mistakes so careful preparation is important to ensure that there are no skeletons or banana skins around in your business that might derail the investment process.

Entrepreneurs should note that investors normally seek to recover their deal costs and particularly due diligence costs from the money raised in the deal and if the funding does not go through, this can often leave the business with a large unwelcome bill.

How Should A Founder Sell To An Investor?

Why is this Important?

This is an introduction to some of the key aspects of how to pitch your business to investors. This is something you really need to master. Pitch badly and your raise will fail before you have started.

The Pitch presentation is the sales pitch by the Founders to the VCs. This document needs to focus clearly on the issues, which are of most importance to the investors.

These include:

- The Product and its USPs,
- The market, market size and why the Product can compete
- The customers, existing and future
- Where customer traction will come from
- The defensibility of the intellectual property
- The composition and track record of the management team
- A summary of the financials, P&L, Balance Sheet and Cash flow
- Existing shareholders/investors and advisers
- The amount of the raise and its proposed uses

What Is The Deal Process From Signed Term Sheet To Cash In The Bank?

Why is this Important?

The deal process is a combination of business review and negotiation. You need to be prepared well to make a success of both parts and a key to this is having high quality investment banking and legal advisers.

The Term Sheet sets out the principle terms of the investment by the investors into the company. Once this is signed the initiative passes from the company to the investors who will have to conduct due diligence and then negotiate and complete all the legal documentation. This swing is often referred to as the Pendulum of Power.

The Exclusivity period is normally 8 to 12 weeks with the VCs preferring a longer period and management should be arguing for the short end of the spectrum. It is important that all enquiries are followed up and answered promptly.

Due Diligence will work through the business from top to bottom and that is where a well prepared data room is essential to a smooth running and successful process. This may include revising and updating employment agreements, sight of all the company's legal documentation including customer agreements, and a property and environmental review.

The Due Diligence checklist is normally a multi-page document organised under these and other headings. Make sure that any red flag issues are identified early and addressed as soon as possible.

The Documentation phase will primarily focus on the investment agreement between the company and the new investors. However, as part of the documentation process the investors may require new articles of association, new employment agreements and may require the IP ownership to be transferred to ensure that its ownership is aligned with the company.

The Due Diligence process can be a difficult process, with a series of meetings where the investors' lawyers grill the founders and their lawyers looking for skeletons in the cupboard. In this regard, the Due Diligence process is an inherently negative process.

The role of advisers and lawyers in this process is important to ensure that the founders understand what is market practice and when the investors take an unreasonable position on an issue.

The founders will need to know when to push back and when not to do so.

It is always better when the process is collaborative and not combative.

It is also important to have complete transparency on fees. In the event of an unsuccessful due diligence process, the VCs, who always try to recover their deal fees from the money raised, will present the company with an unwelcome bill.

The biggest pitfall in Due Diligence is underestimating how long the process will take.

As the whole process can take up to six months, the investors will have an opportunity to track the performance of the company against the business plan presented before the term sheet was signed. Its important not to miss any key milestones during this period.

Summary

Let us try to summarise some of the key points from the seminar.

What does this tell us about the market for VC investment in 2019?

The State Of The Market In 2019

There is no shortage of money but there is, it seems, a shortage of high quality deals.

What Can We Say About Valuations In 2019?

As a result, valuations are high but the number of deals is lower.

How Do You Select VCs?

You need to match the VCs to your business, which includes sector specialisation, funding round stage, geographical proximity and quantum of investment amongst others.

What Are VCs Looking For?

It seems that there are still a wide range of investors from Corporates, Institutional funds, VCT funds, micro VCs and Angels and everyone is looking for the best quality deals in businesses with real traction.

It is more difficult, (it has never been easy) to raise pre-revenue investment as investors increasingly prefer to invest larger amounts and at higher valuations in companies with revenue and customer traction

How Much Money Should I Try To Raise?

Broadly speaking raise what you need, don’t raise more money than the company requires to achieve its next set of milestones, with some contingency and runway to take you through the next funding cycle.

How Long Does The Investment Process Take?

6 months is a good working assumption.

When Is Debt Suitable For A Growing Business?

Venture Debt can play a part in Series A and B rounds, seldom before this. It can be useful in reducing the dilution of the equity in the round but founders should be careful not to over leverage their businesses as this might negatively impact subsequent rounds.

How Should A Founder Think About The Mix Of Debt And Equity?

20% to 30% seems to be an acceptable benchmark.

What Documentation Do You Need?

To start the process you need a financial model, a pitch document and a one page summary. Once the heads of terms are signed, you will need a full data room.

How Should A Founder Sell To An Investor?

This is the purpose of the pitch document which should be a 10 to 20 slide document and should take no longer than 20 minutes to deliver.

What Is The Deal Process From Signed Term Sheet To Cash In The Bank ?

The two main processes to be completed after signing the Term Sheet are Due Diligence and Documentation, which can take 10 to 12 weeks.

Further Information

For further information on the legal issues relating to funding, please contact Simon Halberstam at simon.halberstam@smab.co.uk
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Next Steps

I hope that you found this training helpful and it has provided you with some interesting issues to consider ahead of your own funding round.

If you would like to know more about raising capital for your business from external investors, particularly venture capitalists, then I suggest that you check out some of my other best selling courses on this topic.

Take a look at the Special Offers on the next page.

Special Offer

Special Offer: Get 50% of any of the Courses listed below.
Use Coupon Code "SPECIAL50OFF" or click on the Titles of the Courses (the coupon is included in the link)

Private Equity 101

Startups Get Pitching For Funding Masterclass

Can You Think Like A VC?

Capital Raising for Entrepreneurs

About The Author

John B D Colley MBA, MA(Cantab)

John is a senior technology investment banker with over 30 years experience.

After serving for five years as a British army officer and reaching the rank of Captain, John began his career in finance at Hoare Govett Corporate Finance in 1988 before joining WestLB in 1992 where, from 1998, he specialized in the Technology Sector.

John was subsequently asked to join SG Cowen (Societe Generale's US-based Technology Investment Bank) to lead the European Mergers & Acquisitions team in Technology Services.

He has originated cross-border M&A transactions in Europe, USA and Far East and advised on several medium-sized European acquisitions including German listed Novasoft AG for Ciber Inc. and the Heidleberger Zement acquisition of Indocement in the Philippines.

Since 2008 John has developed a digital technology business focused around Online Courses, podcasting and speaking at conferences. John has over 70,000 students worldwide in 183 countries.

John is an Graduate of Magdalene College, Cambridge (MA), graduated from the Royal Military Academy Sandhurst, and has an MBA (with Distinction) from Cass Business School.

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