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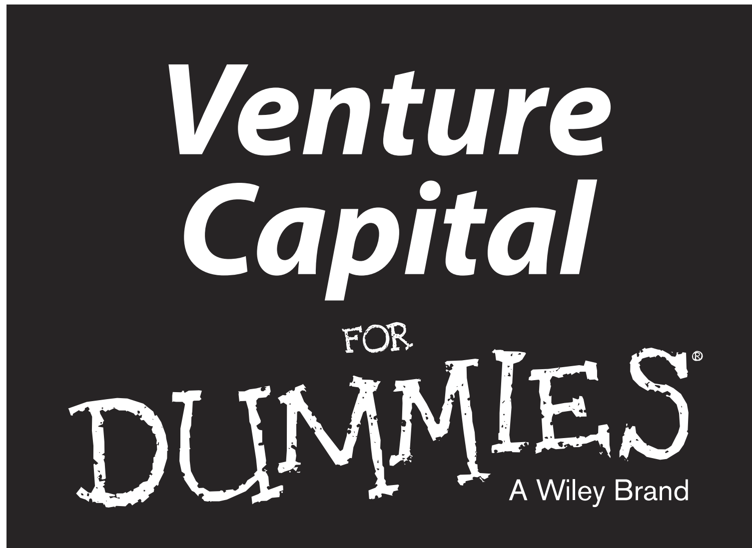


**by Nicole Gravagna, PhD, and**
**Peter K. Adams, MBA**

FOR
DUMMIES
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**Venture Capital For Dummies®**

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# Introduction

If you are reading this book, chances are that you own a company or are planning to start one sometime soon. You are probably thinking about raising venture capital. We appreciate that you have come to us in your search for information. It's okay if you don't know a thing about venture capital or private investments at all. We are here to help! We wrote this book for anyone who's considering seeking venture capital. We help nearly 100 companies each year go through the process of seeking investment. All this time, we have been taking notes on what works and what doesn't.

Venture capital and venture capitalists may seem scary and larger-than-life at first. It turns out that VCs are real people, too! In this book, we demystify the venture capitalist so you can get past that "all powerful man (or woman) behind the curtain" feeling.

Venture capital investment is only one of the many ways that you can fund your company.

- Venture capital investment can help a start-up company attain much larger milestones in a much quicker timeframe than it would otherwise be able to do.
- Companies that take venture capital get more than money. They also get the expertise of the VCs and VCs' network of advisors and business people.
- The venture capital track is the fast track. Companies that take venture capital grow large very quickly or are acquired in a few short years. VC-backed companies don't do anything slowly.

After you read this book, you may choose to pursue VC funding, or you may realize that you have other options that better suit your company and your needs. This book can help you grow your company no matter which path you choose.

## About This Book

We wrote *Venture Capital For Dummies* for smart people with no prior experience raising money from venture capitalists. Founders with great start-up companies come to us every day asking for advice, education, and introductions to investors. We used our experience to create this book.

Through our work at the Rockies Venture Club, we found ourselves teaching each entrepreneur the same information about venture capital investments. We thought boiling all that knowledge down into one little book — this book — would create a handy reference!

Of course, we wrote this book for entrepreneurs, but angel investors, friends of entrepreneurs, and even consultants who help entrepreneurs grow their companies can find useful information here. When everyone in an entrepreneurial community understands the fundraising process, everyone can help support start-up companies.

If you are an entrepreneur, or know an entrepreneur and want to support his or her company, you can find investors. Everyone knows someone who is an investor or knows an investor. This book can help you uncover the investors in your own network.

As you read this book, keep the following things in mind:

- We use the term *venture capitalist* and *VC* interchangeably, reflecting the way the terms are used in everyday conversation.
- The sidebars contain extra information that we think supports the main ideas in the book. You can skip them entirely and still get the full facts.

*Venture Capital For Dummies* is a reference book that you can read in any order you wish. If you are feeling particularly technical one day, you can dive into the chapters about investment structure. If you are more interested in understanding investor psychology, you can read those parts first. Focus on the stuff you want to know.

# Foolish Assumptions

In writing this book, we made some assumptions about you, our dear reader. We guess that you are one of the four types of people that we run into through our work in the Rockies Venture Club. You are probably

- **An entrepreneur:** Not just any entrepreneur, but one who is ready to get his or her company off the ground, grow it fast, and make some money!
- **An investor:** Angel investors and people who invest in their friends' or family members' start-up companies need to understand the future funding pathway for the companies they support.
- **An advisor:** Professional consultants and other smart folks (mentors, advisors, gurus, yodas) who donate their time are most helpful when they can give their client companies the best advice possible.

- **A job hunter:** Jobs are created in start-ups as a matter of course. Venture capital dollars often go to hire key employees. Further, venture capital itself is an attractive industry where both senior and junior VCs can make good money in an exciting job. Either way, this book can help you understand the start-up/VC landscape as a job hunter.

As a member of one of the listed groups, you have come to the right place. We have the information you need to understand venture capital on a level you may not have dreamed possible. If you don't recognize yourself in this list, we welcome you anyway. Have fun. Look around, and we bet you'll find that you learn a thing or two.

## Icons Used in this Book

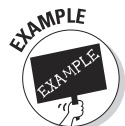
To help you navigate through this book and find the information you're looking for, we've included a variety of icons.

When you're dealing with the future of your company and venture capital, the stakes are pretty high. You'll find this icon whenever you run the risk of losing an opportunity or delaying your company's success.

As experts, we know about and share with you the best shortcuts, workarounds, and timesavers. You'll find them with this icon.

There's a lot to know and to remember when you're doing all the tasks you need to do to raise funds to help your business grow. Look for this icon to find key concepts and principles.

If you're a detail person, you may appreciate these little nuggets of information. Although interesting, we've included them more for fun. Feel free to skip them if you just want to get to the nuts-and-bolts info. Doing so won't hurt your ability to understand or seek (and hopefully) secure venture capital.




This icon highlights the stories of real business that have already gone down the path you're beginning now.

You can find lots of extra info online related to securing venture capital. This icon points you to these articles.

# Beyond the Book

In addition to the material in the print or e-book you're reading right now, this product also comes with some goodies you can access on the web. Check out the free Cheat Sheet at `www.dummies.com/cheatsheet/venturecapital` for information on things you can do to avoid losing a deal, speed up a deal, and find VCs.

Head to `www.dummies.com/extras/venturecapital` to find pointers on how to work with team members who are family, find a securities attorney, and dress for your pitch.

# Where to Go From Here

Go ahead and browse this book. Follow your interests and instincts. No previous knowledge is required! Start with a chapter that seems new and interesting or maybe even begin with a topic where you feel more experienced. Head to the table of contents or the Index to find topics that you want to know more about immediately. The table of contents is a great map you can use to find information listed chapter by chapter. The index lets you really want to drill down on a topic. If you're completely new to venture capital, why not begin with the chapters in Part I?

Wherever you go, you're sure to find useful information.

# Part I

# Getting Started with Venture Capital

getting started with venture capital

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## *In this part…*

- Discover the mindset that sets founders of venture businesses apart from other business owners.
- Get the lowdown on what venture capitalists look for, how venture capital fund works, and the legal restrictions that impact which companies are selected for investment.
- Determine which funding options — venture capital, angel investors, crowdfunding, and more — can best help your company meet its growth goals.
- Take the first step to securing venture capital by creating opportunities, online and face to face, to attract the attention of a venture capitalist.

# Chapter 1

# Nothing Ventured, Nothing Gained: Venture Capital Basics

### In This Chapter

- Getting familiar with venture capital and venture capitalists
- Determining whether you have a venture company
- Seeing the whole venture capital process

If you're starting a new business, welcome to the club! Starting a business can be the most exciting, scary, enlightening venture that you embark on. If you've been running a business for a while and are just starting to look for money, you've come to the right place!

Venture capital is often misunderstood and feels like a big cloaked, black box to many people. In reality, venture capital is pretty easy to understand after you've been given the basics. Further, venture capitalists are more open about sharing information than people think. You just need to know where to look for the information.

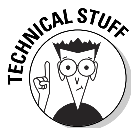
In this book, you discover which companies benefit most from venture capital, how venture capital works, how to connect with VCs, and when the time comes, how to pitch to investors. We also describe the whole start-up funding landscape and explain how to navigate it wisely. This chapter introduces you to venture capital and provides a general overview. Consider it your gateway to this exciting world.

## Understanding Venture Capital and Venture Capitalists

*Venture capital* is a very specific type of investment for a very unique type of company. Venture capital–backed companies are expected to grow extremely fast — much faster than other companies. In addition, VC-backed companies

are sold after five or seven years in an acquisition or on the stock market in an initial public offering (IPO).

VC-backed companies have the potential to make millions (billions?) of dollars for investors and founders. Because of the huge windfall possibilities, a lot of people are interested in creating companies that are attractive to VCs. Nevertheless, venture capital is not a necessary part of building or growing your business. In fact, companies can do very well without venture capital and the involvement of venture capitalists.




Technically speaking, venture capital is just like any other investment, an asset class. Venture capital investments are high risk and also potentially high return. Not all investors want to be involved with venture capital (sometimes called *risk capital*) because of the level of risk involved.

The following sections introduce you to the venture capitalists — the people who invest the money in start-up businesses — and the kinds of companies that are prefect for venture capital.

# Introducing venture capitalists

*Venture capitalists* are the professional investors who give start-up companies money in exchange for equity in the company. They provide both liquid capital and support for a company during a fundamental time in the growth of the business.

Venture capitalists are responsible for bringing together large amounts of money for an investment fund (called *raising a fund),* which is then used to invest in companies, hand-picked to become part of the VC's (or VC firm's) portfolio. The VC and his team choose companies that are capable of growing very large very fast, earning the VC firm many times its initial investment.

Venture capitalists know that not every company in their portfolio will produce a huge return on investment, and so to tip the hand in their favor, VCs do two things:

- They invest in companies that have excellent odds of being successful venture-quality companies.
- They support the companies in their portfolio with resources like mentorship, board members, and strong management.

Companies that work with venture capital give up an element of control in exchange for the opportunity. Most founders find the exchange worth it for the added capital, support, and connections that come with an investment of venture capital.

## Knowing what VC firms look for

Venture capital firms tend to specialize. They focus on a specific stage of company and one or two industries. A VC firm may focus on companies in the medical device field, for example, or maybe in clean energy. Because VCs deal with risky investments, they have to make sure that they understand their chosen industry and technologies inside and out. Therefore, your company must fit into the firm's profile before the firm will consider investing. (You can usually find out which industries a VC firm invests in on the firm's website under the About Us tab.)

### Focusing on different stages

VCs may invest in seed stage companies (companies with no revenue or little revenue) or stage 2 companies (those with $5 million to 50 million in revenue), or they may fund mergers and acquisitions of larger companies. Companies of different sizes have very different issues and needs. For more on the different fundraising rounds, head to Chapter 9.

### Focusing on specific industries

Venture capitalists must be experts in their chosen industries, understanding it completely. This expertise is especially important because the best portfolio companies have game-changing technologies that disrupt markets. Predicting the success of companies that don't have any contemporaries is a very challenging task!

### Focusing on the company's progress and potential

Most venture capitalists, even those who invest in seed stage companies, look for the following:

- That the company has a product or has made a lot of progress toward a product
- That the company has a strong team that can execute its plans
- That the company has connected with its target customer and understands its market

These factors impact your company's risk level. Investors have a level of risk that they are willing to accept in a company. Investors interested in later stage companies want you to have removed more of the risk from your company by progressing through necessary milestones. Seed stage investors are more accepting of risk and use a high risk profile as a way to get more equity for the same investment dollars.

## Getting familiar with the VC fund lifecycle

Venture capital funds don't last forever. They tend to run on a predictable, ten-year cycle. To give you a better idea of your interactions with VCs, we've paired their activities with yours over the lifetime of the fund.

1. Investors spend the first year raising a fund from high-net-worth individuals (accredited investors), corporations, and institutional investors like pension funds. You aren't involved at this point. If it's a new firm and/or a new fund, you may not even know that the VC exists yet.
2. VCs spend the next few years finding companies to add to their portfolio (called *sourcing deals).* During this period, you'll get introduced to a VC through a mutual contact, or you'll submit your pitch deck to the VC through the VC's website (find out more about pitch decks in Chapter 15.)
3. After the company is given investment and becomes part of the portfolio, the VC proceeds to manage the company. Generally, VCs do this by joining the board.

   VCs are very helpful to entrepreneurs throughout the investment relationship. They tend to act as the voice of experience in the relationship because they've been through company building many times. During this time, you'll be working hard to develop new products, increase revenue, and basically do what you do best — run your company.
4. As the fund nears the end of its lifespan, the VCs work to liquidate the companies through mergers and acquisitions. If the company does very well, it may go public and become a company traded on the open stock market. If the company isn't doing well, it can be shut down and its assets sold separately.

   It's the VCs job to sell your company to a buyer. It's your job to let him. This is how you cash out and take home the spoils of your hard labor.
5. As all the companies in the portfolio are sold, the money is returned to the original investors (limited partners) who entrusted their cash to the VC, and the VC fund closes. At this point, you're free to do whatever you want. Your formal relationship with the VC is over, and you can start a new company, get a 9-5 job in a corporation, or retire.

# Choosing the Venture Capital Pathway

Companies that benefit most from venture capital are those that have a disruptive technology or product that they aim to grow very large very quickly. Entrepreneurs who benefit most from venture capital are those who want to create a great new company and do not need to retain full control over it as it grows.

Companies that have a tried-and-true product or service may not benefit from venture capital. Venture capital also may not be right for the company owner who likes to retain primary control or has always dreamed of handing the business down through generations. Chapter 3 is all about determining whether venture capital is right for your business.

When you work with venture capital, you make tradeoffs: You control less of the company and receive less of the total cash after your company sells. On the plus side, you have a support system of smart VCs, and your risk is distributed among more people.

## Identifying a good venture business

Your traditional coffee house, clothing store, photography business, landscaping business, restaurant, real estate development company, and filmmaking company don't make sense as venture capital-backed companies. Different kinds of industry-specific investors put money into those types of companies.

Venture capital tends to invest in companies built around software, drug developments, medical devices, engineering devices, and other cutting edge technologies that are considered disruptive to current markets. (*Disruptive technologies* are innovations that could not have been predicted; therefore, their effect on the market as a whole cannot be predicted either.) VCs look for disruptive technologies because the potential for a huge return on investment is greater when the business hinges on very risky technology or market integration. High risk can equal high reward.

Of course, not all technology companies should be venture capital–backed companies. Many of technology companies would do well to grow organically — that is, without large investments of capital — and develop at a slower rate. Organically grown companies can be big winners, too. In fact, if you can get your company to profitability without taking outside investment, you may stand to make more money. Chapter 3 contains all the information you need to start deciding which track your company should take.

## Looking at alternatives to venture capital

If you decide that the mega-high growth, high stress, venture-backed start-up company lifestyle isn't what you signed up for, you can grow your company as a small-to-midsized business (SMB). Compared to venture capital–backed companies, SMB companies tend to require a lot less capital, grow more slowly, and remain more stable as they grow.

Smalls business have lots of different ways to raise money, including through bank loans, crowdfunding, friends and family, grants, and franchising. Chapter 4 goes into detail about all your options as a business that ultimately chooses not to raise venture capital.

## From Zero to Venture Capital: Knowing What to Do to Secure Venture Capital

The most successful venture capital businesses are not just good at what they do; they are also lucky. Because you can't do anything to improve your serendipity, you can plan your business from the beginning in ways that remove hurdles and increase the possibility of success. Follow these suggestions:

- **Start by thinking about the end.** When you look back on this business from the future, what do you want it to look like? Plan for the results that you envision. Chapter 8 tells you what your exit options are and explains how to prepare for your exit.
- **Target a huge problem that has a huge market.** VCs want big exits. The best thing that you can do to set your company up for VC funding is to go after a huge problem with a huge market. You can't sell a company for billions if it has an esoteric or limited market. Head to Chapter 6 to find out how to position your business to attract a VC's attention.
- **Get your feet under you.** VCs don't fund companies with grand ideas until the company shows a lot of progress toward revenue. This progress is often referred to using the word *traction*. Chapter 6 tells you what key components — business plan, product development, marketing strategies, and more — to focus as you prepare your business for venture capital.
- **Become visible.** You can increase the likelihood of getting funded quite a bit by simply meeting the funders. Make friends with investors. Get to know the VCs and the larger start-up community. *Schmoozing* isn't a bad word anymore. Chapter 5 has a number of suggestions for connecting with investors, both online and face-to-face.
- **Develop the deal.** Not only do you have to develop the company, but you also have to design a great investment deal. Investors like working with founders who know how to put their due diligence materials together and who have working knowledge of a term sheet. These concepts aren't rocket science, but getting familiar with the process does take time. Get cracking! And go to Chapter 9 for the details.
- **Start pitching.** After your company has gained traction, your deal is structured, and VCs know your name (or at least your face), you need to start pitching for investment. Pitching is such an important and involved task, that we dedicate an entire part to it: Part IV.

The following sections delve into more detail on three key points: getting your company ready, designing your investment deal, and approaching investors.

## Preparing your company to attract interest

Just as you would prepare your home when you put it on the real estate market, you need to get your company prepared for investors: Gathering the right advisors, making sure your records and certificates are in order, planning your future growth, and really connecting with your customer are all important points when getting ready for investment.

### Coinciding fundraising efforts around milestones

One of the hardest things to do in fundraising is to know when to start fundraising. The good news is that you don't have to decide on one particular, set-in-stone date. Instead, one way to ensure you have the funds you need when you need them is to time your fundraising between milestones. Identify all the major milestones that your company must tackle before you achieve profitability, and then plan your fundraising efforts to coincide with the period of time after you've just attained a pretty nice milestone and right before you tackle the next one. Your just-completed milestone will serve as a great story that shows your team's ability to execute.

Notice that this suggestion isn't "begin fundraising after you complete development of your whiz-bang product." You can — and should — begin fundraising rounds earlier than that. The key is to know your business, know your market potential, and be able to show progress toward your goals. Chapter 6 includes information about business plans, product development, promotion strategy, and communicating your future revenue streams before you ever earn a cent from your product. Head to Chapter 14 for a checklist to determine when you should start fundraising.

### Polishing your company for investors

Get your company to a point where you feel comfortable having a figurative open house. Many companies are moving and developing so fast that they have ugly loose ends everywhere. You have to polish your company to raise money:

- Show your market research in ways that investors can follow. Raw data may be okay for you, but the investor is going to want to see well-designed graphs.
- Revise your business plan and business model regularly so they reflect the new information that you have learned since you originally wrote the documents. Write a two to three page executive summary for investors (they don't have time to read the whole thing).
- List all the strategic partnerships, mentors, advisors, and other supportive relationships that you have made.
- Plan out employee needs in the near future and start talking to potential candidates even if you don't plan to hire for 12 months.

Chapter 6 has even more ways to get your company VC ready.

### Connecting with customers early

Many companies think that they cannot begin to connect with customers until they have a finished product to sell. Nothing is farther from the truth. You can, and should, be connecting with targeted groups of customers as you develop your product. By the time the product is finished, you will have a small group of happy customers whose excitement you can leverage to promote sales. It's never too early to talk to a potential customer.

### Adding expertise to your business

The number of people excited about your company can be indicative of future success, and VCs like to see lots of high-quality people who are willing to put their names on your company.

You can really increase your credibility with VCs by adding expertise to your team in terms of an advisory board or through strong mentors. Don't think you have to pay a ton of employees to have a big team! Chapter 7 is all about relationships and tells you how to get people involved in your company and your deal in many different ways.

## Putting together the deal

Developing your business is only one part of raising capital. You have to develop the deal, too. Basically, the deal is the amount of money that you need and the percentage of the company that the investor will get in return for capital under certain conditions. Conditions can include requirements for milestone achievement, involvement of certain industry experts, or many other things. Chapter 9 discusses the deal in detail; following are some key points.

- **Lay out your company's plans for the future and determine how many times you'll have to raise capital to achieve your goals;** then coordinate your capital raises with big milestones (refer to the earlier section "Coinciding fundraising efforts around milestones"). Investors would much rather invest when they know a large milestone will be attainable with the capital raised. Matching capital to milestones is akin to raising enough money to put a person through a four-year degree. Nobody wants to invest in something that only gets the job three-quarters of the way done.

  Companies raise venture capital after early rounds of angel capital, friends and family investments, or bootstrapping the company for a while. In Chapter 9, you can see what a normal funding pathway looks like. You also find information about the term sheet, differences between equity and convertible debt, and how to avoid pitfalls in early round deal structure.