Venture Capital – Explained

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In the world of high-tech in general, and Israeli high-tech in particular, venture capital is the main avenue for funding new technology companies. Despite the prevalence of VCs in the start-up world, there remain misconceptions among entrepreneurs about venture capital funds and how they operate. **Shai Tsur** of **Giza Venture Capital** examines how venture capital funds work and what motivates VCs when evaluating investment opportunities.

What is a venture capital fund?

Let's start with what VCs are and what they aren't.

Entrepreneurs often complain about VCs. One of the most common complaints is "VCs are supposed to like risk, but they are really only looking for the next Google and other sure bets."

Contrary to popular opinion, VCs are not wild-eyed gamblers, nor do they particularly "like" risk. Part of the confusion here is local and comes from poor translation. In Hebrew, the term "venture capital" is *hon sikun*, which literally means "risk capital." (A more literal translation into Hebrew would be *hon yozma*.) In other words, the emphasis needs to be on the venture rather than the risk.

Venture capitalists are first and foremost financial investors who specialize in investing in technology companies. Now, it is true that all start-ups carry some degree of risk. The earlier one invests in a company, the greater the risk. The risk is just part of the business, not something that is particularly liked or disliked.

It's also inaccurate to say that VCs are looking for "sure bets." While it would be terribly nice to invest in the next Google, who knows what the next Google is? As the old cliché goes, who back in 1997 would have thought that the world needed another search engine?

Another major misconception is that we are haughty Masters-of-the-Universe types. The fact is that we do not ultimately control our own destinies. As Bob Dylan once wrote, everybody has to serve somebody. And, in the case of VCs, that "somebody" is our investors. The majority of money in VC funds comes from large institutional investors, such as pension funds that manage tens and sometimes hundreds of billions of dollars. These investors earmark a certain part of the money to high risk/reward vehicles like venture capital. In return, VCs try to provide a significantly high rate of return.

What does this all mean?

First, this setup dictates the VC business model and the types of investment opportunities that tend to fit this model. More about this later.

Secondly, it means that every few years VCs have to go hat in hand to their investors in order to raise the next fund. VCs, like the start-ups in which they invest, all know how it feels to be the ones asking for money, to sit through seemingly endless meetings, to go through a rigorous due diligence process and then to wait around impatiently for an answer. This probably won't win us any sympathy points with the entrepreneurial community, but it's worth mentioning anyway.

Baseball and the VC model

Venture capital funds tend to work within the confines of a fairly specific business model, which in turn influences which companies the funds choose to invest in. This VC model has become fairly infamous in recent years, with a lot of people in the industry (mainly non-VC investors) claiming that the model is flawed and even broken.

The VC model often gets explained in baseball terms. As a quick reminder for those who might not remember or even know the rules, baseball involves batters who swing at baseballs being pitched to them and who try to complete a circuit around three bases and return to the starting point.

A majority of the time, the batter will miss the ball entirely. Some of the time, he will hit the ball hard enough to allow him to get to one of the three bases (a "base hit"). And every once in a while, he will hit the ball hard enough to send it flying outside the baseball diamond and let him run around all the bases for a score. This, of course, is a "home run."

The traditional VC model is supposed to work similarly. Of ten companies that the VC invests in, seven companies will either fail entirely or just return their investment, two will be moderate successes ("base hits") and, with some luck, one will be an rousing success – a "home run." The base hits and home runs are supposed to cover the investment in the seven companies that flopped and still provide the necessary returns for investors.

Let's say a VC fund raises $150-200 million from its investors and makes 20 investments averaging $8-10 million over the lifetime of each company. In order to make the returns expected by its investors, the fund assumes that of the 20 investments:

- two will be huge successes and return 10X on the money,
- four or five will return 2-3X their investment and
- the remainder will either just return their investment or be written off entirely

The successes, as mentioned above, need to be big enough to cover the inevitable losses from those companies that fail.

So how does this influence the fund's

investment decisions? For one thing, it means that VCs need to focus on those companies which they believe *at least have the potential* to be home runs and return 10 times their investment.

One of the most common reasons we have for passing on companies, including companies where we think the team is great and the idea is solid, is that we feel that the opportunity is too small.

(There are no fixed rules regarding how small is too small. But, in general, a company that cannot show a target market of at least $500 million is probably too small for VC funding.)

While the investment multiple is important, it's not the only consideration. The actual amount of money that is returned is important as well. Small exits (let's say under $40 million) can be very good for company founders but not so great for the VCs that invested in them. In other words, if a VC makes a seed investment of $2 million, and the company exits for $20 million, this is not considered a big success even though it had a multiple of 10.

Why is this? Even if the VC held 30 percent of the company at exit, which is on the high side, it only received $6 million. In order for a $150 million fund to make the returns that investors expect, it would have to have 30 or 40 exits like this, which is unrealistic. So VCs look for exits that they believe have the potential to be $100 million or greater.

Obviously, we know that most companies will not have $100 million plus exits. But since 7 out of 10 companies that we invest in are likely not to succeed as hoped, we need to know that the three that do, at least have the potential to succeed big-time.

So, why all the talk of the model being broken?

There is a perception that the size of exits has shrunk over the course of the decade. Fewer companies are going public and the ones that do are doing so at a much later stage, after much more money has been invested in them. With fewer IPOs, more companies exit by being acquired, which often means smaller exits.

It's unclear to what extent these assumptions are true, but if they are, then the number of exits that return a 10X multiple shrinks, which affects the model greatly. On the other hand, the cost of starting a company, especially in the Internet world, is a lot smaller. Perhaps a larger number of companies will produce moderate exits, which will cover the ones that don't.

The VC model will have to be adapted. If it's not broken, it may yet have to bend.

The investment process

You can envision the VC investment process as a multileveled pyramid. At the bottom of the pyramid are all the companies which pass through a fund each year, be it at the level of sending a business plan, pitching to a VC at a conference or being contacted by the fund proactively. At the top of the pyramid are the small handful of companies that receive investment in any given year. At every one of the levels in between, the fund will decide to pass on the majority of the companies.

The numbers can be pretty daunting. To give you an idea, in any given year, something like 1,200-1,500 companies enter the process with Giza Venture Capital. We will meet with some half of these companies. And the number of new investments that the fund will actually make is in the area of six.

Roughly speaking, the process can be broken down into the following stages:

1. **Locating potential investments.** It all begins with what we call deal flow: finding the companies that are looking for funding. This comes from a wide variety of sources. Some funds have dedicated professionals whose job it is to find and contact new companies. Many others come in via networking. Still others contact the fund, occasionally submitting their business plans via the Web site.

   In addition to identifying new companies, we also spend a lot of time reevaluating companies that we have seen in the past and that have made progress with their technology and/or their business development.

   At this stage, we drop a certain percentage of companies, which are clearly not suitable for us (sectors that we don't invest in, etc). Those that pass, go to the next level.
2. **Screening and reevaluation.** Each week, the fund holds a screening meeting, where the investment professionals discuss new opportunities. We look at 20-30 companies, discussing the main points of their business plan or presentation. At this meeting, team members request to meet with those companies that seem interesting. About a third of the companies make it through the screening committee and actually meet with the investment team.
3. **Initial meetings.** Following screening, the fund's investment professionals (often in teams of two or three) will hold an initial meeting with the company. This is usually a 90-minute meeting where the entrepreneurs present themselves, their idea and their vision. At the end of the meeting, the VC team will discuss whether it is worthwhile to move forward with the company.

   About a quarter of the companies that make it to initial meetings will pass this stage.
4. **Due diligence.** This is the longest and most involved part of the investment process. Depending on the type of company and the complexity of its technology, the due diligence process can take anywhere between a month (in the case of companies going through Giza's fast-track "Ofek" program) to four or five months.

   During this stage, the company will be called in for more meetings at the fund to delve further into its technology and market. Often, the VC will call in outside experts to help the fund evaluate a company's technology. The company will also make a presentation to all the investment professionals in the fund to allow them to decide whether or not to invest. At the end of this stage, if the investment still looks good, the VC issues a term sheet.

   Only about 5 percent of the companies that enter the due diligence process emerge with a term sheet in hand.

5. Closing process and investment. The final stage of the investment process involves negotiations on the terms of the investment. The VC will perform additional legal and financial due diligence on the company. Some companies will still drop out of the process (usually due to the company deciding to reject the term sheet), but the others emerge as winners of the VC sweepstakes.

It's a long process, and it can be an arduous one. As one entrepreneur once said, the odds of becoming a pilot for the Israeli Air Force are better than getting VC funding. However, we would like to think that the results are worthwhile.

What makes a VC investment?

Having looked at how the workings of the VC model and the investment process, we need to tackle the question that most entrepreneurs have, namely, "Just what is it that you people are looking for?"

There is no one simple answer to this question. There are so many different factors that come into play when deciding to make a VC investment that it is impossible to generalize a rule. However, many VCs have a framework when they consider investments: technology, market and team.

The ideal start-up would have the following combination of traits:

- Technology/product – The company has an innovative product which leads the next-generation in its field. Its technology has significant advantages over the competition, has the potential to be disruptive and has strong IP protection.
- Market – The company operates in a market with significant potential (theoretically in the billions of dollars), as well as double or triple digit annual growth rates and proven success stories and exits.
- Team – The founders are a dedicated group of men and women with passion, drive and vision; people who have a deep understanding of the market they are operating in and have experience in similar ventures, a group of individuals who balance and complement each other.

In the real world, of course, very few companies fully fit that description. So, you start looking for combinations of factors. As a general rule of thumb, it's enough that a company has two of the three components (technology, market and team) for it to start looking interesting.

Which two components depends on the fund to which one is speaking and quite often the specific investment professional looking at the company.

As a general rule, Israeli VCs tend to emphasize team and technology. This comes as a result of Israel's position in the world. As a small country, with few national resources and a tiny local market, Israel's biggest asset is its people and especially the Israeli talent for finding clever technical solutions to tough problems.

The fact that Israeli companies have traditionally excelled technologically more than anything else leads to a certain bias in that direction. However, over the last year, local VCs have begun showing increased willingness to fund companies whose strengths are less technological and more innovative in their business model and/or their target market. Giza's investment in Koolanoo Group, which develops a Chinese social network, is one such example, but there have been numerous others. Internet companies have a tendency to fall into this category.

It should be noted that the three different factors have different weights. In reality, the issue of the founding team counts for more than the other two combined. A great team is critical, no matter if you are a technology or market play.

A great team, the thinking goes, will be able to adapt its technology or business model as market conditions change, so it doesn't actually matter what the initial product is. And if the entrepreneur is good enough, a lot of funds have entrepreneur-in-residence (EIR) programs, where they work together with the entrepreneur to build a company from scratch.

What makes a great team? That's another difficult question. Ideally one should have a person who is very strong technologically, another who is strong on the business side and a third person who can manage the operation. The team should also be able to work well together, during the crisis points as well as the good times.

Final thoughts

So now we have looked at how the VC process works. Hopefully, this has provided some insight into what goes through the heads of those guys sitting across the conference table from you when you make your pitch. To close, here are a some tips and comments:

Patience please. One of the biggest complaints of entrepreneurs concerns the pace at which things move in the VC world, especially compared to processes with angel investors. Yes, it does sometimes seem that VCs lumber along at the pace of asthmatic dinosaurs. But the pace is often dictated by the process and the need to assure investors that their money is being invested wisely. You have our apologies for this, but we do ask for a little patience.

Perseverance. According to a well-known joke, the hardest answer to get from a VC is "yes;" the second hardest answer is "no." VCs are infamous for never giving a straight-up no. Instead, it's usually a "not now." Not now, because we don't think the concept is fully developed enough, or we want to see what kind of uptake it will have or because the team doesn't seem strong enough.

While this is understandably frustrating to entrepreneurs, you should also look at the other side of the equation. VCs understand that things change very quickly in this business. Subsequently, we try to maintain ongoing contact with companies that we have passed on in the past as their situation changes.

Just to give one example, we had a company come in early last year with a concept for an Internet site. The idea didn't seem fully baked, so we gave the founders a bit of constructive criticism and parted ways. Two months later, they contacted us again. They had changed their model and suddenly seemed a lot more interesting. We ended up providing seed investment.

The moral of the story: even if we tell you "no," don't walk away angry. Update us when you have significant developments – you launch your product, you start getting users, you add people to your team. You'd be surprised how often that makes the difference.

The ideal entrepreneur. Lots of people planning a start-up wonder what we look for in an entrepreneur. Personally, I am most impressed by people who know their stuff. They have a strong handle on the technology and the market and can stand up to a barrage of difficult questions while maintaining a cool head. That plus real passion and devotion to the idea and the capacity for a ridiculous amount of hard work is the mark of a real winner.

Help keep us honest. As mentioned, entrepreneurs like to complain about VCs. Some complaints are justified, others less so. One can find numerous forums and sites on the Web to compare notes on VCs. The most prominent (and infamous) of these is probably The Funded (http://www.thefunded.com), where entrepreneurs gather to complain about VCs, and VCs read and then wring their hands about their image.

I invite everyone to visit the site and contribute, as it helps keep us honest and improve our service. I do have one request: be fair. The fact that we didn't get back to you with an answer (a really bad and common VC trait) is legitimate cause for complaining. The fact that we didn't like your idea, however, doesn't necessarily mean that we're idiots.

So, why VC? At the end of the day, a lot of entrepreneurs will be tempted to ask, "Why should we bother with you guys?" In other words, why should they put themselves through a long and unpleasant investment process with a VC fund instead of just going to angels. If you are a software or semiconductor company, the answer is obvious: we've got deeper pockets than most angels.

But I'll put the banal answer aside for a second in order to make this point: In many cases, we are learning how to act like angels. Giza's seed stage "Ofek" program is a good case in point. We have learned how to make relatively small, initial investments and to do so relatively quickly. Often we invest with groups of angels.

This kind of model can be found in almost all the funds here and is often used for companies in the Internet space. For the entrepreneur, it gives the best of both worlds. ■