

UNLOCKING VC

JOHN COSTELLO
LOOKS AT THE
VENTURE CAPITAL
MARKET AND
HOW COMPANIES
CAN GO ABOUT
RAISING FUNDS.



The venture capital market looks set to make a significant comeback with 80 per cent of Irish venture capital companies expecting to increase investment in new projects in 2005, according to a new survey by the Irish Venture Capital Association (IVCA).

But it is not only new-to-market entrepreneurs that will be the focus of the estimated €100 million IVCA members have at their disposal to fund Irish businesses. The study showed that 40 per cent of IVCA members also expect to increase funding in existing investments, while 40 per cent will maintain investment levels in existing projects.

The findings point to a venture capital market that is bullish for the first time in four years.

“The VC market has bounced back,” said Shay Garvey, head of the IVCA. “There was a recession across the whole technology sector but since then large corporates have been making large profits. Global companies are cash rich again and the top US 500 publicly quoted firms are sitting on cash assets of \$3 trillion. They need to ramp up their R&D again and many will do this by buying firms with good technology. There has never been so much cash on balance sheets of corporate America.”

The impact of this strong optimism is already prevalent. Venture capital investment in Irish companies has seen huge growth in the first quarter of the year with €75.4 million already invested, according to Ion Equity’s quarterly Techpulse survey. This accounts for more than twice the amount invested in the previous quarter. Indeed, the first quarter figure is also almost half the total amount raised last year.

ACT Venture Capital, Trinity Venture Capital, Intel Capital, Apax Partners, Cisco Systems, Amadeus Capital Partners and Polaris Ventures were all involved in Irish investments in the first three months of 2005. NTR and Kilsaren Concrete Products bagged the single biggest deal, with €18 million invested in broadband service provider Irish Broadband.

Three Irish companies — Corvil, Aepona and Irish Broadband — each raised more than €15 million in venture capital funding in the first quarter. During the first three months of 2005, a total of 12 companies raised funds. This is more than any quarter since 2003. The average deal size of €6.3 million is 35 per cent up on 2004.

GOLD?

However, while it would seem that the VC route can be paved with gold companies should always approach with caution.

QUESTIONS TO ASK BEFORE APPROACHING A VENTURE CAPITALIST

- Does my company have high growth prospects and is my team ambitious to grow the company rapidly?
- Does my company have a product or service with a competitive edge or unique selling point?
- Can it be protected by intellectual property rights?
- Can I demonstrate relevant industry sector experience?
- Does my team have the relevant skills to deliver the business plan fully?
- Am I willing to sell some of the company’s shares to a private equity investor?
- Is there a realistic exit opportunity for all shareholders in order to realise their investment?
- Am I prepared to accept that my exiting this business may be in the best interest of all shareholders?

Source: IVCA

"The VC route is not for everyone," said Garvey. "For example, service companies generally don't need VC but if they are building a product they may need funds to develop it.

"If I were raising money I would go to Enterprise Ireland first. I would tap my friends and family and business angels. And then go to the IVCA site to check out the VC options."

The VC route is tough and once a deal is done, which is by no means an easy feat, milestones must be met and a company's performance will be monitored on an ongoing basis.

"A VC representative will sit on the board of the company seeking finance," says Garvey. "If a company doesn't deliver in terms of meeting the milestones there will be changes made. Experienced VCs know that this is a risky business. But it is important to keep in contact with the VC so there are no surprises."

Typically a VC will lose a quarter of its capital when investing in businesses, according to Garvey. It will break even with 50 per cent of the remainder. However, it is the other 50 per cent where they will make a multiple of their investment.

"Because of the potential for high returns the risk is also high," says Garvey. "The VC by doing a lot of investments in various funds can diversify their risk by spreading it across all sectors."

David O'Donnell of Mason Hayes & Curran agrees that all options in terms of raising finance should be explored before a company decides on VC.

"They should not only consider the venture capital route but they should in turn look at all other forms of finance including from family and friends, banks, government bodies, such as Enterprise Ireland, and the Business Expansion Scheme," says O'Donnell.

Once the decision has been made companies should prepare themselves for what lies in wait.

"Dealing with a Venture Capital company is a little bit like having your insides opened up," says O'Donnell. "There is vigorous due diligence and companies need to supply a very in depth business plan. You need to be groomed and prepared before going to a VC provider. The most important aspect is to have someone who has been through the process before advising you. You will need a combination of corporate finance and legal skills at every stage of the process. You basically need someone who can give you high level advice."

INVEST

Those companies not willing to invest in the preparation will not get far.

"Some of the clients we have seen wouldn't be entertained by VCs," says O'Donnell. "We've come a long way in the last six to seven years. There would have been a significant level of naivety around 10 years ago and certainly in the dot com era where guys would come in with a business plan and throw it on the table and say they are worth 10 million. That type of naivety has been killed because venture capitalists have had to be brutal in their investments. They will now not entertain anyone who is not stepping up to the mark. You won't even get in front of VCs if you can't present a solid business plan."

"Irish entrepreneurs are probably a lot more savvy now. That said the VC market has also matured and will not repeat the mistakes they made in early 2000 after the blood letting of 2001."

The first milestone is to get yourself in a position where you can present to a VC. You will need to develop a highly tuned business plan and then make a formal presentation. It is normal to get the VC companies you are presenting to sign a confidentiality agreement. If they seek to engage with you, you will have a number of presentations to make.

"You will get a term sheet, which is not a legally binding agreement stating what they are willing to put in for what per cent of the company, the positions on the board and the due diligence they will be carrying out," says O'Donnell.

"From the time you present to the time it takes to get a term sheet could be as little as two months. From there after you can have anywhere from between four weeks to 4-5 months before completing the deal. They will generally want to do a legal due diligence, financial and tax due diligence and will usually get a third party to review the technology. It is quite a testing time and there is no guarantee that they will close the deal."

THE ROAD TO VC

3Q Solutions as founded by a group of financial services industry professionals and technologists, to develop enterprise and web-based wealth management solutions for financial services companies.

It has raised over €1 million to date but is biding its time before going down the VC route.

"I wouldn't advise anyone to go near venture capital until they have customers," says Brian Hanly of 3Q Solutions. "It takes a lot of energy going around to venture capital people and that time is better spent going around getting customers."

They have tapped into funding from a various array of sources.

"The way we did it was we invested ourselves to get it kicked off," he says. "We then secured private investment through contacts, Enterprise Ireland and the Business Expansion Scheme [BES]. We raised €1million. The next round of investment is going to be through the BES and Enterprise Ireland."

In its cautious approach towards VC, 3Q Solutions has hired a third party Strategic Equity Partners to guide it towards its enviable engagement with VC.

"From all the documentation we have concerning our business they have pulled it all together into an investment plan, which is no trivial task," says Hanly. "They have advised us on valuations and identified potential investors and qualified these. We are at arms length and are able to focus on the business. They bring us to meet hot prospects. We pay them a retainer fee, which is not prohibitive. But like everything else I would advise people to negotiate everything. They then will get a percentage of the funds raised."

So is it easy to find where the funding is?

"Yes, I guess it is relatively easy," said Hanly. "However, it can take a lot of time. The key is to do it at the right time. I think it is important to have clients especially if you are a software company. It needs to be a proven piece of software from a VC perspective and having clients is the best way to show this. They do heavy due diligence on the management and on the financial side."

However, Hanly strongly believes that VC should be used to grow the business rather than develop it from scratch.

"I think any capital gained should be spent on the sales and marketing of software rather than on the manufacturing of it," he says. "When we do go down the venture capital route we will look at that money purely to expand our business. The majority of VC should go towards increasing sales and sales should then fund your growth."

Once a VC is comfortable with the business plan, the management team and the due diligence proves positive then they will want to close the agreement.

"There will then be a shareholding agreement drawn up," says O'Donnell. "Once both parties sign to complete the deal the money is usually given in tranches, which are released on the achievement of certain milestones. This will see the equity drip fed over a period of time against certain key performance criteria."

"There isn't generally a high drop out rate once they issue a term sheet. The commercial deal is done unless something terrible comes out during due diligence. From my own personal experience three in ten fall out of bed. The reason can be varied but it generally is because something comes up in due diligence that wasn't discussed."

According to IVCA there are currently 22 Irish VCs, 20 lawyers, 10 corporate finance people and 30 to 40 business angels. All there to offer advice and help companies along the road to investment. "At anyone time there is probably 1000 tech companies of which about 220 have got VC," says Garvey of the IVCA who believes the process to access VC is more transparent than ever. "If you arrived from Mars within two weeks you will be able to figure it out."

For those seeking more information a good starting point is the IVCA website at www.ivca.ie