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How to Play the Venture Capital Game

By Chris Berkner, Managing Director of One Earth Capital

Please note that this document does not constitute legal, investment or professional advice but rather should serve as an informal introduction to the subject of venture funding.

Know the VC Market

Many entrepreneurs who are fund-raising for the first time face a steep learning curve. For you "venture virgins" out there, we recommend that you spend at least a couple of days explicitly educating yourself, and then expect the educational process to continue.

We recommend that you start by choosing an experienced venture attorney who has done a significant number of venture investment deals, preferably with some of those deals being in your sector. Your attorney should be able and willing to make introductions to venture capital and/or angel investor groups. The attorney should also be able to help you in the negotiation process, by explaining each of the various terms in the deals being proposed and how each deal compares with other deals the attorney has facilitated. If you go with a big, established firm, make sure you have access to a senior partner who can give you the experienced guidance you're going to need to understand and negotiate the intricacies of venture deals.

Three Kinds of Entrepreneurs

We can generally group fund-seeking entrepreneurs into three categories:

1. Those who know how to play the VC game and are ready to play. (These are usually CEOs with previous fund-raising experience.)
2. Those who don't know how to play the VC game but are ready to learn.
3. Those who don't know how to play the VC game and aren't particularly interested in learning. These entrepreneurs want to write their own rules.

If you fall into category 1, congratulations, and we can't wait to meet you. Same for you category 2 people – but please do read everything we have to say and prepare yourself a bit before jumping in. Most category 3 people probably aren't reading this – but for those that are, we wish you luck. Some of you may have temporary funding success with a generous angel investor who is willing to give you millions of dollars for a tiny fraction of ownership of your company. This sounds good, but in the long run can lead to a dead end, since you will effectively "orphan" your company from the rest of the investment community by overpricing your shares too early. We believe you will have greater success if you learn and play by the rules of the VC game and choose your investors wisely; or alternatively, eschew the venture world entirely and either bootstrap your venture or find debt financing at reasonable terms (easier said than done).

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The Valuation Issue

Ideas of valuation vary fairly widely from one beginning entrepreneur to another, and to some extent from one investment firm to another. Investments in early stage companies are generally categorized into "seed", "Series A" (early stage), and successive Series B, C, etc. ("follow-on"). Investors speak of the "pre-money" as the value of the company before the investment is made, and the "post-money" as the value of the company after the investment. So for example, if a company raises a Series A round of $4M and gives the investors 40% ownership of the company, the "pre-money" is $6M and the post-money is $10M.

Generally speaking, very small startup companies that are just beginning will be seeking seed investments, which typically range from $100k to $1M. This money is often raised from friends, family, or angel investors, and usually goes toward "proof-of-concept" technical development. The company should be prepared to give up around 20%-30% of its ownership to these investors.

Most Series A rounds involve raising between $1.5M and $5M. The company should generally be prepared to sell 40-45% of its ownership to the Series A investors. Most often, Series A investments will occur only after a company has proven its value with a prototype, proof-of-concept, issued patent, or an established revenue stream. Some very young companies (especially those with experienced leadership) may skip the seed stage and proceed directly to the Series A financing.

One Earth Capital typically invests in the seed and Series A stages, and will generally follow with an investment in the Series B round. Our maximum investment per round is $3M but we often invest $500k to $2M and occasionally make smaller seed investments. We usually prefer to co-invest with other investors who bring additional strategic connections and experience to the table.

We strongly recommend starting with a very reasonable valuation, so as to quickly gather interest in the investment community, and so as to maintain the upward momentum of your stock price over successive rounds. Too often, we see companies raising seed rounds at unsustainably high valuations, and then "stalling out" in the next round, when other (generally more savvy) investors lose interest because the valuation is too high. If you stick with the percentages here (selling 20-30% of the company to seed investors, and then 40-45% of the company to the Series A investors), you will increase your likelihood of staying on the road to success.

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How to Choose an Investor

There are hundreds of venture capital firms involved in green technology; some of them, like One Earth Capital, invest only in green technology, while others have a much broader portfolio. Each of these firms has a particular strategy or investment domain, and a range of investment sizes it will consider.

The high-tech landscape is full of stories of clashes between VC's and management. There are also many VC stories of extreme synergy and success, where the VC becomes an essential part of the company team by bringing focus, connections and strategy as well as capital. Consider the following:

Values and Chemistry

Do you "hit it off" with a potential investor? Do you generally agree with their values and respect their intelligence? There are few things that will take the wind out of your company's sails like frequent, fundamental differences of approach and communication styles in your board meetings.

Connections and Industry Knowledge

This is a no-brainer. VCs can help make connections in all sorts of ways, from strategic partnerships to recruiting to rounding up other investors. Experience in your industry is an obvious plus, but if you are operating in an industry where few VCs are active, you may have to settle for quick learners.

Size and Time

Larger investment firms may be able to take your company further by providing larger amounts of capital and multiple rounds of financing. But remember, all investors expect to get their returns within a certain timeframe. Some VCs will expect to get a return in three to five years while others can wait as long as seven (or occasionally even ten). You should have an exit strategy and make sure it fits with your VC's expectations.

Also, some VCs may have more on their plate than others. Do you want a VC who will pay attention to and actively support your company? (If you don't, perhaps you haven't found the right VC yet.) Make sure you and your investor have compatible expectations around investor involvement; otherwise, you may end up feeling either ignored or micro-managed.

Your Attitude

If you can't find a VC you like, you may need to examine your prejudices. Many entrepreneurs fail to attract investment because they assume every VC is intending to "screw" the company. We're not claiming that you should assume that all VCs have your best interest at heart – but we are saying that you need to have an open mind and ask

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around about who you're dealing with, rather than always expecting the worst. There are some parts of the process where your interests and your investor's interests may be intrinsically contrary, but we believe that if all parties maintain a reasonable approach to the terms and issues that arise, and make efforts to understand the industry norms and why they exist, a collaborative relationship based on trust and mutual respect can be developed… and we believe trust and mutual respect are very helpful in ensuring a company's long-term success.

Getting Started

Before you even start talking to investors, you'll want to have certain items prepared – the executive summary, the PowerPoint deck and the financial model. You can read about these in our separate document, Effective Business Plans.pdf.

After you are well prepared with the aforementioned items, you'll want to start making connections with investors.

Getting It Out There

There are differing perspectives on how to go about getting your company known. We recommend attending as many networking events as possible and having your executive summary ready to send out as a follow-up to any connections you make. You can also consider applying to present at conferences or angel groups (like the Keiretsu Forum) or listing your investment opportunity on networking sites like www.cleantech.com. Probably the best way to get traction with VCs, however, is to be introduced by someone they know, which could be a mutual acquaintance or your venture attorney.

Good Luck

If you think you've put together a company we'd be interested in funding, send us your executive summary (see Contact Us) with a short introductory email highlighting the most interesting features of your company. We at One Earth Capital wish you great success in your endeavor.

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