Protect Yourself and Your Startup

ADVICE FROM A SEASONED VENTURE CAPITALIST

Raising venture capital is not for every founder, but it's a major engine for big ideas that have founders who desire fast-growth.

My Hockey Stick study shows that firms that raised VC grew larger faster than those that did not raise VC. After the second year, for firms that didn't accept VC investment, the median revenue was $358,000, while for those that did take VC money, median revenue was $463,000. But by the seventh year, median revenue for those that raised VC was $29.6 million versus $11.6 million for those that didn't. But whether this means that the VC cash and guidance helped accelerate growth or whether the VCs did a good job of choosing firms to back because they were well equipped for growth can't be determined.

How do venture capitalists evaluate deals? How do they want to be approached by those seeking investment? What are the main terms negotiated when you raise venture capital? How do venture capitalists earn a living? What type of founders do venture capitalists seek to risk their money with?

About David Jones:

David is a 12-year veteran in the venture capital industry. He is a former soccer player at Navy who soon thereafter became a Naval aviator and team leader. He later earned his master's in management information systems from University of Virginia and an MBA from University of North Carolina at Chapel Hill. Despite his professional accomplishments and academic smarts, David is a humble, giving person. He's also a straight shooter.

Bull City Venture Partners, the VC firm David and his partner, Jason Caplain, founded in 2013, has invested in great startups throughout the region. Additionally they manage two funds and are partners at Southern Capitol Ventures, where they invested companies such as ReverbNation (a solution that helps musicians advance their careers), Channel Advisor (an e-commerce platform that IPOed on NASDAQ), Motricity (an online advertising platform that IPOed on NASDAQ), and Art.com (a platform that helps artists sell their work online). Bull City's slogan is "Founders First"—upon which they have built a stellar reputation within the red-hot start-up scene in the Triangle (Raleigh, Durham, Chapel Hill).

Learn more at Bull City's website www.bcvp.com.

How many deals are pitched to Bull City each year? How many do you fund?

David: In 2013, out of 962 deals pitched to us, we did three of them. But we're a very concentrated venture firm. There are a lot of venture firms that spray it out there, and they'll do one or two per month, and they're just spraying out seed bets. For us, we invest in a really, really, small percentage.

Why do you close such a small percentage of the deals you see?

David: That's just our model. We are waiting for the right team, in the right market, at the right time, at the right price–just being very patient. But I can tell you a lot of stories about missing some good deals because we waited too long for the right price, or because we waited for the company to prove that their business model was viable.

What factors make a deal attractive to you?

David: We look at management, market, and momentum. The quality of the founders and team probably accounts for 70% of our decision. The market also needs to be big, ideally $500M or greater. Email marketing was a good example. Everybody has email marketing. It's applicable to everybody. It's a huge market.

The last thing for us is kind of nebulous; we call it momentum. Momentum has to do with how much measurable progress you're making. Momentum can be measured with number of users, it can be eyeballs, it can be clicks, it can be revenue, it can be growth in the sector. For example, e-commerce continues to grow at a double-digit rate, whereas retail stores continue to fall.

What are some common mistakes founders make when fundraising?

David: They raise too much money too early. A lot of founders believe their idea is the best idea in the world, when in reality, they should prove it out first–get to the point of being able to repeat success, and then step on the gas. Innovation happens with constraint. If you constrain the amount of capital you have, you'll be forced to make better decisions, and then there will be a time to grow it.

A lot of entrepreneurs will give away too much equity too early to a big name or what they think will be a big advisor. Conserve your equity. Your equity is your gold. The idea is that equity's going to be worth a heck of a lot more than anything else.

Some entrepreneurs don't pick the right investor. Do as much due diligence on an investor as they're doing on you. That's really, really important because it's truly a marriage but harder to get out of.

What is the best way to approach a venture capitalist?

David: The best way to approach a VC is a referral from an accountant, a lawyer, or from another entrepreneur. If an entrepreneur we know and trust refers you in, I am going to take that meeting every time. I am going to listen intently, do my homework beforehand, and I'm going to get to know the business.

What you don't want to do is email a list of VCs at info@. Don't do that. That's a bad method to approach VCs, and I can honestly say we've never done a deal that's come over the Internet like that. To me, that's test number one in the survival of the fittest of the entrepreneurs. Can you find a way to efficiently get in front of us? Can you comfortably get a good referral into a VC? You should be able to. Otherwise, maybe you're not very well-networked.

When should you approach a VC? When you need money or beforehand?

David: Again, VCs invest in people, so we want to get to know you. I love it when you come to us with an idea, when you've talked to a couple of customers, when you've started building it, and you can demo it. You're telling us you're going to do this, and you're starting to do it, and a customer gets engaged. A great VC friend of mine says, 'We invest in lines, not dots.' The first time I meet you, that is a dot. You're going to tell me you're going to do something, and that's the next dot. We can

eventually string together a line; that's the way we like to operate, and I think that's the way most VCs like to operate– getting to know you, seeing how you work.

Most of the founders we have known for a year or more, but occasionally a shorter timeframe. We just invested in a company in D.C. where we had a lot of touch points because they were founders we already knew. We got to know the team for about 120 days. We were constantly seeing them, getting to know them, going on a customer call with them. Talking to all the other people. I'd say that's the quickest: three or four months.

I always tell the entrepreneur: get us engaged. Get us helping by allowing us to introduce you to a perspective customer. It's a great customer prospect for you, but it's good due diligence for us because I can call that customer afterwards and say, 'What do you really think? Did you like it? Would you pay for it?'

That's typically the way we like to operate. The entrepreneur should work to get investors engaged. The more we're engaged, that's usually a good sign that we're interested.

What are the main terms negotiated during a VC deal?

David: There are three important ones for us: 1) price, 2) the right to continue to participate, and 3) the preference. The valuation, or price per share, I think that's probably the one term we try to get right. If we disagree on price, I'll tell an entrepreneur, 'If you don't like the price, I'll give you the price, and let me make all the other terms.' There's so many different ways to make it meet.

Participation is the ability to participate in future fundraising rounds. If we've invested, then we want the right to continue to hold that position, if we own 10% of the company, we want the right to hold that percentage ownership.

Another important one is that if things go bad and you sell the business, we want the right to get our money out first. There's a reason for that. If you own 70% of your company, and we own 30%, and we agree that it's worth $5 million, tomorrow you get an offer to sell it for $4 million, well you're going to do really well personally, but we will lose money. We want to make sure there's a method to at least get our money back, and sometimes more than our money back, first. That usually goes away as the exit gets bigger.

There are other small covenants like you can't take debt over a certain threshold without board approval.

How long does the process take from receiving a term sheet from a VC to closing the deal?

David: A term sheet offers how much we want to invest in your company and under what terms. From the time we submit a term sheet to the time we invest is usually 30 days. There's a negotiation process that takes a couple of weeks to get to the term sheet. Once we agree on terms, then each side does due diligence. We'll usually allot 30 days where we begin digging under the hood into your technology, we're doing background checks on you and the team, and doing some market analysis. Then, 30 days later, we wire you the money. Then we’re on the same team.

It takes a while, but the most important part to us is that time before the term sheet. Usually if we're putting a term sheet in front of you, we want to do this deal and want to find a way to make this happen, and hopefully have completed a good portion of the due diligence.

What are your main criteria for determining a company’s valuation?

David: During the early stages of a startup, valuation is much more art than science. People always think being a venture capitalist is a finance job. But if you're investing in a seed deal, it's just an idea. There are no revenues, certainly no earnings–there's no way to financially calculate what an early-stage business is worth. It usually comes down to something like: This type of business, for example, a software business, in North Carolina, at this stage gets a valuation in about this range. If you have a serial team, maybe it automatically goes up a couple million bucks. If you

don't, maybe it goes down a million or two dollars. It's really a negotiation with the team.

At the seed stage the biggest driver is making sure you get the ownership right for both sides. How can we make the amount invested, the valuation, the ownership amounts for the team and for the investor at the right amount where everyone is happy?

As the company grows, and it has revenues, and it's maybe starting to near break even, then it becomes much more of a math game, and you can run comparables, discounted cash flows, and other financial modeling techniques to determine valuation.

Once a start-up has a million in revenue, or two million, what's the range for valuation relative to their annual revenues?

David: Two to five times revenue is probably a normal range for a software-as-a-service company. Some are getting done north of five times revenue. I think there are good cases for a higher range if you're growing 200, 300 percent, year over year–there are some pretty good cases where you're getting seven, eight, nine times revenue. It's all driven by that growth rate. But I'd say a normal range for an IT company is probably two to five.

Beyond just money, what value do VCs bring to the table?

David: You can get cash from a lot of places, but somebody who can add value to your business, such as connections, advice, who has sat in your shoes before, and can help you move the business from Step A, to Step B, to Step C much quicker than not having them.

A VC should bring lots of connections and a huge network. They should help you raise future financings. They should be helpful with recruiting. We helped recruit the CFO, a VP of product, and a CTO at one of our companies. They should help with sales and business development. We love getting on a flight with our entrepreneurs, taking them out to the Bay Area, and walking them into a customer or partner introduction.

What types of “controls” do founders lose when they accept VC?

David: It’s super-important to us and our investing model that founders keep a large ownership percentage of their company and not lose control too early. The founders and the team are the visionaries and the experts in their field. VCs are rarely the expert in the business. We are there to help you, support you, stand by you, invest more money, but we are rarely the expert. So we are big believers that the founding team always has to have enough equity to keep them motivated.

If a founder chooses to take on VC dollars, they are choosing to take a different path and not become a lifestyle business. In order to make a return for our investors (called Limited Partners), we have to “exit” the business at some point in the future….usually through an M&A event or an IPO. Founders are also giving up some controls of salaries, ability to take debt, governance on building the team, and much more, but hopefully all of that is well understood before entering into an agreement to take venture dollars.

There is also a lot of momentum around founders keeping more control by creating new classes of stock. Some founders create a separate class of stock, sometimes called “Common A” or “Common B.” This stock has more votes than the other stock of the business.

If you accept VC, should you expect to eventually have to sell your company?

David: At the end of the day, if you do take venture capital, you are signing up for some way for the investor to get their money back. Ultimately, the way we make our money is by some transaction that happens where we can sell our stake in the business. But that can happen in a bunch of different ways. You can IPO, or you can be acquired. But private equity exits are also becoming popular. If we start a company early on, and we grow it for five, six, seven years, and it's doing well, the private equity groups can come in and write a much bigger check. A lot of times, they are our exit, or our partial exit of the company. I think you're seeing that become more prevalent.

Occasionally, we've had companies that have issued a dividend, but that's very rare. We have one company that's just very profitable and growing, and they issued a dividend for the first four or five years. Again, fairly small. We have one company that did a dividend recap of the business and got us all our money back and kept our ownership. I would say dividends are not our preferred way to do it, and we would rather not do that, but it can work, and there are a couple of cases of pretty large companies where all they do is, again, spit out a huge dividend, pay back their investors over many, many, many years, but I think that's really rare. Usually it's an IPO or a merger acquisition.

Describe what traits a great entrepreneur possesses?

David: Other than the fact that they're crazy enough to quit their day job, most of the best ones can "see around the corner." So they're able to say, 'Hey listen, this is a market I know well and I think the future is going to be over here, and we're going to build something.' And sure enough, it happens. They are passionate about their idea and have a vision towards it.

The great entrepreneurs are great leaders. Because they have to convince people to join them, take a pay cut, work 100 hours a week, and that takes a leader. If you're not a good leader, you're not going to convince a bunch of people to join your mission

Most of the teams we work with also have more than one skill, one founder is strong on the business-side and the other technically. It's a one-two punch.

What traits do you look for in CEOs/founders who are seeking VC?

David: One is past successes, and that can mean past successes in anything, even college. It doesn't need to mean, what I described earlier, where you've founded three companies and sold them off, but something that proves that you're different. You just get that feeling that this guy or gal is going to walk through 17 brick walls to get it done…to please the customer…to get a customer. And that's the feeling we want to get.

That being said, founders are crazy…usually in a good way. They're different. You have to be different to be a founder. You're jumping off the boat and taking this big chance on an idea, so I think you have to accept a little bit of craziness, but I think we also look for, again, a good leader.

For us we like that one-two punch, so maybe a technical person who's very adept at the technical side, and then a sales-focused CEO. If you look across most of our companies, our CEO is the number-one sales guy, certainly for a while. I hate when founders say, 'I'm just not very good at sales. I need to bring in a VP of sales,' Jeez, that's your job. When you start a company, for the first couple years, you have to do sales. You need to be better than anybody.

What actions do you take when an investment isn't going as planned?

David: The board tries to decide what the plan is. Do we need to get hot and introduce you to a bunch more customers? Do we need to get some more customer feedback? Do we need to change out the team? Do we need to put more money in and give us some longer runway to give it a go? Or do we need to unload it, and sell the business?

We want to be super-active when things aren't going well. We want to jump on a plane, and we want to be there with you. Ultimately, we're going to take our cues from the founders. If the founders say, 'No, it's not the time to sell; I think we need a little bit more time,' we're going to listen, and maybe put a little bit more money in and trust you. If you say, 'Hey, it's time to sell,' we're certainly going to take our cues from that and maybe agree.

Is it true that if a founder accepts VC, there's a chance that he or she could be fired?

David: For some, that is their model. Certainly, the later-stage growth VCs and the private equity guys, they might have their own person to put in the business, so I think, again, it goes back to making sure you get to know the VC you're working with. A board member's job is to hire and fire the CEO. The CEO hires and fires

the team. The board hires and fires the CEO. So if the CEO is not cutting it, then our job is to replace them.

For us, we're betting on the founder. So we have to get that right. Again, it's a rare few who can take it from the ground all the way through an IPO, but that's what we're looking for! We will spend all the time in the world to get that right.

I'm not a huge fan of completely getting rid of the CEO because they're the people that have been in the business for the longest time. They know where all the warts in the business are. If they are no longer CEO, make them the VP of Product, or Chairman of the Board.

Are pivots, or taking a big change in direction, acceptable courses of action?

David: Yeah, we've done that a handful of times, where we've invested in companies that have changed directions a few times. It's difficult in some ways because you're investing in this business, and then it's changing, which is another reason why we invest in people and not the business. .

How important are financial projections in your evaluation of a startup?

David: I'll categorize looking at financial projections in two ways. If it's a seed deal, I am less focused on the projections, and more focused on your expenses. How can we get the maximum amount of time to figure out if we have something? How can we give this thing a good 12-15 months of time to figure something out?

Now, if you're past the seed stage, then I put a lot of credence in maybe *next year's* projections, but after year three, year four, I don't even look at that. The one time I do look at that is the rookie new entrepreneur who says, 'The first year, I'm going to do a million, second year ten million, third year forty, fifty million.' That usually just means that you don't have as much experience really knowing how a normal business scales.

How do VCs earn a living?

David: We get paid a management fee to manage the total pool of money in the fund. The fee is usually 2 or 2.5% of the total pool size and pays for our salaries, rent, marketing, travel, and other expenses. Once we have given the investors back the full amount they invested in the fund, then everything above that gets split, 80-20; 80% to the investor, 20% to us, the managers.

Note: Most VCs also invest in their own funds as well.

How specialized are VC firms?

David: I think in the last 10 years, more and more firms are getting very, very specialized. At Bull City Venture Partners, we are fairly broad and the reason for that is our geography somewhat requires that. If you're in the Bay Area, I think you can be more specialized because there are 50 times the number of startups. Here, in the Mid-Atlantic and Southeast. I think we have to keep that a little bit open. We don't usually do hardware companies, life sciences companies, plain bricks-and-mortar companies. It's usually software, e-commerce, digital media, healthcare software.

What’s the difference between seed venture capital and growth venture capital?

David: Seed capital comes during the idea phase when a founder is working on the product that usually is not yet released. It may have a couple of beta customers at the most. But then once you have a couple customers, you have some proof that customers need your product and will pay for it, then you are beginning to cross into growth capital. A lot of people call that a minimum viable product.

But five or 10 years ago, a seed round was only a PowerPoint presentation. There was no code, no product, and it was just an idea. That's still my definition of a seed round, but I think that's changed a little bit now, and is sometimes called pre-seed investing.

Then there's growth capital. That's when you basically add fuel to the fire–you want to speed up that process and grow the business.

Venture capital can do both of those. I would say most venture capitalists probably do more of the growth side of the business as opposed to investing at the pure seed stage, and the angel investors probably do more of the seed stage and less of the growth.

What do you think about the TV show Shark Tank? Is it realistic?

David: My kids enjoy watching it, but it's certainly a bit Hollywood the way they do deals fast. It’s not how we do deals - we're trying to get to know founders over a period of time. The show makes the funding process a transactional business, and it's actually a relationship business in my opinion. But the entrepreneurs get up there and pitch their business like we would usually hear a pitch, and a lot of times the sharks are investing with a twist to it, or a term that is atypical for a normal venture-backed company, but a term used to protect the sharks downside.