Week 4 – Angel Backed Companies: Getting Through a VC Transaction

This is the fourth part of our series of blog posts focussing on issues faced by young companies. White Lake's team are experts in the identification of these issues, origination of solutions and execution to ensure your business does not fall into any of the pitfalls reported in our Series B investment blog.

So your business has developed and grown successfully and it is now time to get VC capital in – to put you on a faster path to growth then exit – with a strong institutional Board.

Two things are important at this stage:
1) Being ready for a process
2) Deciding what type of process to run. The negotiations, structuring and due diligence will come later

At its core, raising capital is a sales job – nothing more complicated. The product is your company, the agents are the bankers and the buyers are the VC funds who are buying a stake in your company which they intend to make a profit on when they sell.

Being Ready For VC Due Diligence – A Level Deeper Than Angel DD

An exercise I like to do with companies aspiring to raise capital is to put the management team in the shoes of the VCs – so they can be prepared. When working as a VC a question I always asked myself which helped bring clarity to a situation was this: ***"What do I need to believe to make this investment?"*** Ask that question and stand in front of a whiteboard and the important drivers and assumptions will start to become clear: *"We need to believe X customers will come on-board in the first six months….", "We need to believe the cost from suppliers will drop on volume purchases by X%..."* – the exercise then is how to get comfort on these assumptions by research. The trick as a business owner is to see the risks (or perceived risks) **AS** a VC will view them ahead of the transaction. Then you can work at proving the assumptions/beliefs as best you can while demonstrating on how you will mitigate the risks.

VCs will run a much harsher and deeper due-diligence process than typical angels. They will not take your word at face value but will want proof for every assumption you are making. They will often hire outside professional advisors for financial DD, legal, IP DD and even commercial DD. You need your data room prepared to a high standard well in advance. There are very good low cost ways to set these up. Dropbox is as good as any if well laid out in a segmented way. For these types of venture capital transactions, I don't recommend nor see the benefit of costly third party data room providers. Of course, having segmented pre and post NDA (Non-Disclosure Agreement) data is also important. I would leave off having to sign NDAs with VCs for as long as possible into the process as this puts some off.

This should go without saying but nonetheless – try never to start a process with less than 6 months cash left – 9-12 months is optimum. If you aren't in this position, perhaps one last angel round is the way to go first.

Type of Process to Run

The typical investment bank will run a broad process on a capital raise or an M&A transaction to increase competition and increase the likelihood of a deal at the desired price. I do not advocate such a broad process for attracting VCs. Deal flow is the **LIFEBLOOD** of a VC firm. They want to find the good deals first and avoid an auction. To increase the likelihood of your preferred group of VCs pitching a term sheet – you need to put them in a process where they feel they are not in an auction and have a good chance of **winning the deal.** They can only look at so many deals at a time so choosing one with a good chance of closing is important to them.

I recommend picking 5-10 of your top targets and liaising with them in a very informal personal way. Like in any sale, building a relationship is vital especially as you will have to work with one of these VCs for years once the deal closes. That being said, even with a more informal process, you still need to set time limits with a target term sheet date and a close date. The skill of the dealmaker is to get the VCs there without forcing them.

Always let your prospective investors know that an early term sheet with favourable terms will get them exclusivity on the deal.

Negotiation & Structuring

In our original start-up problem set a few weeks ago I mentioned an issue which will now come to the fore – one of valuation. What if your Angels were overly ambitious and set the previous round's valuations too high for the VCs? I have seen this happen with multiple companies.

So the easy way out of this is to apply the old adage ***"You set the price and I set the terms"***. Many VCs will be happy to accept a potentially high price (I mean who really knows how to value these deals?!) in a structured preferred equity deal, however, it may then be loaded with harsh terms for the original investors. For example, while they may well accept your price but load the term sheet with X times liquidation preferences, anti-dilution clauses, vetoes/controls on certain decisions and redemption dates. So be careful with a high valuation – if they want to know if you truly believe the valuation and will back yourself, the VCs will load the terms and see your reaction.

My recommendation to Founders is to get sensible valuation advice from experienced dealmakers and if you must – negotiate both ways – back to the angels and with the VCs. Of course, management are on the side of the Angels however being on the side of getting a deal done and growing the pie is often the best way forward.

Board Composition

To be frank – you don't need to worry too much about this. The VCs will set this up in the term sheet. The likelihood is that all the Angels will be represented at this point by one Director. From my experience letting the VCs set up the Board the way they prefer is often best. Angel Directors have a lot of useful advice however the VCs have the experience to drive a business from this point forward to IPO/trade sale.

Closing

Once you have corralled the VCs and received a term sheet you are happy with (or two if you are lucky) it will be time to go into a period of exclusivity to close the transaction. This is the period when your initial preparation before the start of the transaction will come to the fore and now your finance team will come under increased pressure. The neat data room, preparation of financial models, preparation of management for sometimes gruelling meetings, poring over numbers and plans will be critical. You will need to have your top customers prepared to take calls from the VCs.

Where companies often fall down is not being able to legitimately back up the assumptions in the financial model. Again, preparation with experienced dealmakers who have been through this process before will help. You need to be honest with yourself upfront because if you are hiding something or being overly optimistic chances are it will come out. If the deal dies then you will be under significant pressure going back to the VCs who fell away earlier in the process or you will be looking for emergency funding from your original Angels. A failed process could spell the end of your business; hence get it right first time!

When going through a process such as this, attempting to run your business as usual can become very tough. Make sure you have adequate resources to back up yourself and your team as you embark on a capital raise. I've often seen firms – who due to bad processes end up in continuous fundraising mode. The stress and damage to the business can be immense.

To end on a positive note – plan well – be realistic about your business prospects and valuation – and then if it is good enough – it will attract capital.

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