

COLUMNISTS

Raising capital

VC investments from a CFO perspective
By Steven Erdahl and Joseph Durnford

Imagine that you're CFO of GreenWidgets, Inc., a 3-year old company which applies nanotechnology to produce green materials for the construction industry. The company's talented work force of about 20 members comes from the scientific community and has little experience operating a business. They recently developed a possible breakthrough product, inventing a way to yield much better performance from insulation. The upside potential is staggering, combining nanotechnology with environmentally-friendly products.

Despite this initial success, however, many unknowns exist:

- How do they transition the product from an idea to actual manufacturing and distribution?
- What is their target market?
- From where will the money come to pay the costs of manufacturing?
- How will they assemble the increased workforce necessary to move the company forward?

How to raise capital

All companies need capital to operate and grow, generated from a combination of internally-generated profits, incurrence of debt or issuance of equity securities. The proper makeup and allocation of these capital sources is an important strategic element in managing the company's financial condition. Without sustained growth, whether measured by sales, free cash flows, EBITDA, or by some financial ratio such as return on assets or return on equity, a company can't compete well in the long run.

While growth is the lifeblood of a company's valuation model, the question of how to finance such growth opportunities is often difficult to answer. Given the many investment alternatives available to investors, if they fail to realize growth in their stock they may pull their investment in favor of other opportunities.

For early-stage companies, capital can come from various sources. First, businesses can apply for a loan from their bank, but such applications are often denied due to financial requirements beyond the reach of young companies. Most don't have much collateral to offer, nor have they established a positive trend of profits with which to support a line of credit.

A second source of capital is to solicit funds from angel investors, wealthy parties willing to invest funds in exchange for a sizeable equity allocation. However, such angels often limit their exposure to less than \$500,000 per investment.

A third source of capital may come from venture capitalists: professional investors who specialize in providing funds to growth stage companies. Many issues should be properly addressed to create a positive dynamic between a CFO and VC.

The role of a VC

In general, a VC's overall role may be separated into three stages. Initially, a VC must strictly screen companies for inclusion in the Fund's portfolio. The first screen for many VCs is that the opportunity was referred from their circle of trusted relationships (industry brethren, management teams they've worked with previously, investment bankers, lawyers and accountants).

Given the relatively high-risk present from investing in early-stage companies, VC investors demand a commensurately high return on their investment. VCs must carefully analyze potential portfolio target companies and search for the most lucrative investments, all done through the due diligence process.

The VC will typically conduct the following analyses of the target company:

- Interview the management team
- Review the marketability and overall demand for the products and services
- Complete detailed financial analysis of the operations
- Quantify the support (if any) for projected revenues and cash flows. It is not uncommon for only about one or two out of a hundred target company candidates to be ultimately acquired by the VC fund.

Once a target company is purchased by the VC fund, the VC enters its next stage, playing an active operational role in the portfolio company. VCs are not passive investors. They demand positive financial results and will provide managerial and strategic input in many ways to improve the bottom line.

The final stage of a VC's role relates to its exit strategy for the company, the ultimate goal of which is often to take the company public in an IPO. Such an event is the best way to objectively measure the increase in value of the investment. In general, a typical VC investment is expected to result in a sale or other liquidity event within a defined period.

Keys to a successful relationship between a CFO and VC

The key to a successful VC funding is choosing the right partner at the outset. Companies seeking VC investment must identify a solid partner, who brings more than just money. The VC should understand the industry, the technology, the market opportunity and be able to add value through its experience and relationships.

Only after identifying the right partner, can the CFO negotiate a term sheet. In selecting a VC partner the CFO must carefully interview multiple candidates, asking tough questions.

Due diligence is not a one way street; yes, your business needs capital, but it also needs a partner it can trust during both good and bad times. CFOs must ascertain whether the VC understands the company's business operation. Does the VC have realistic goals and expectations? What level of funding will be needed and provided? Will the VC make a good partner? To be successful, the CFO and VC must build a relationship of mutual trust and confidence that can withstand the many challenges that lay between funding and a successful exit.

Like any other relationship, the parties must properly manage their expectations. In some cases VCs have become wrongly synonymous with vultures circling a carcass, but logically the portfolio company has the idea or operation and the VC has the capital funding. Each party is an important contributor to successfully moving the company forward.

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