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Venture Capital Investments

A private equity investment is usually defined as an equity investment in a privately owned company. There are two main types of private equity investments:

1. Venture Capital; and
2. Mezzanine and Buyout.

This newsletter will focus on venture capital investments.

Venture Capital ("VC") investments are investments in young, immature, "high-growth potential" companies.

From the Investors' Perspective

Private equity firms specializing in VC investments will look for the following characteristics in reviewing target acquisitions:

1. A strong management team.
2. A strong value proposition to the end user of their product or service.
3. A sustainable competitive advantage usually in the form of proprietary technology in order to create barriers to entry from competitors.
4. A scalable business model. In other words, something that can be produced in large quantities without significant capital investment. An example of this would be computer software.
5. High margins.
6. Significant return potential. VC firms target returns of three to 20 times their initial investment.
7. A large potential market size; and
8. An opportunity to exit the investment in five to seven years time. This can occur in many different ways but is usually done through an initial public offering or a merger or acquisition.

Most VC firms invest in only 1% to 2% of all of the deals that are presented to them. And of those that they invest in, the returns are usually subject to the "2-6-2 Rule," which states that 20 percent of investments will be "winners", 60 percent will be low-producers and will not produce the required rate of return and 20 percent will fail and go bankrupt. The winners will usually pay for the remaining 80 percent, thus producing the required overall rate of return on the entire portfolio.

What this means is VC investors may need to review up to 500 opportunities just to find the one investment that will be a winner and exceed their required rate of return.

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Investors will obtain enough ownership (usually around 35%) to exert some control without restraining the founders' entrepreneurship. They will also require Board representation in order to have a say in the strategic direction of the company. A shareholders' agreement will be entered into which will state what decisions will require Board approval vs. those that only require management approval. The financial reporting requirements will usually be more formal and frequent than they were prior to the investment.

From the Founders' Perspective

It's always a challenge for entrepreneurs who are used to making all of the decisions to have to answer to someone once an investment is made in their company. And there will be significant pressure on the founders and management to execute the plan and grow the business. Managing the company during a growth stage while having investors to answer to will be far different than running it on a shoestring with limited cash resources. Investors may insist on adding to the team a few managers with experience in growing similar businesses.

But the upside to an investment is having adequate capital to grow the business in areas that would have never been possible without it. Being able to expand into markets at a faster rate will give the company a huge advantage over its competitors. Growing a company organically takes time and it is usually more difficult to grow the business if a competitor has superior resources or a first mover advantage.

Aries Advisory Group can help you and your company to source a VC investment. We can assist you in developing and preparing a business plan and all other due diligence information for potential investors to review. We can then assist in the negotiation of a purchase price and shareholders' agreement with the chosen investor. Please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.