2017

Cleantech.org

Author: Neal M. Dikeman

[ANATOMY OF A PROTOTYPICAL VENTURE CAPITAL RAISING]

Summary of the venture capital fundraising lifecycle.

Contents

Overview

Despite the investment of venture capitalists in a profusion of data and analytics technology startups, venture capital itself is not a very data driven industry. Industry practitioners will often argue that it is not a sector that succumbs to predictive algorithms. However, like bond and various derivatives markets before it, this may not be entirely true. And many practitioners will argue that a "pattern recognition" exists among experience venture capitalists.

It is certainly possible to reverse engineer that pattern or "the logic of venture capital", and since quite frankly, general investment principles in venture capital tend to exist for a reason, venture investments on average do tend to have lots of similarities. Or thought of as: venture investors tend not to fund companies that do not look like the others.

Over the years Cleantech.org and its prior parent firm Jane Capital Partners LLC conducted a number of studies using basic benchmarking and comparative analysis techniques, Monte Carlo simulations, rational expectations and simple game theory scenario modeling, and process flow modeling techniques to analyze and reverse engineer what happens in a successful venture round by round, and successfully used this information to create a recipe of sorts for successful spinouts.

We used the "3 strikes you're out" rule. Once an investor reaches three elements in their pattern recognition on any given deal that fall outside their general expectations for a deal at that stage, they tend not fund. Also known as, if the deal looks like a typically venture deal, the likelihood of funding goes up.

To that end this brief summarizes some of the key elements of the pattern recognition, which we used not to "game the system" per se, but to focus our efforts on the critical path to creating value under the theory that the pattern recognition of investors exists for a reason. And which has the additional benefit of increasing the funding hit rate, and increasing the predictability of the fundraising time frame, of a given startup.

Anatomy of Venture Deal

Anatomy of an A Round Deal

Typically an A round is raising single digit investment with cash to last 2 years. Expect 1-3 investors, with 1-2 lead. Use of milestone deals is reasonably common. Use of capital is largely to prove key technology milestone and market validation, hire team.

A round investors generally expect:

- Customers don't have to be closed yet, but some sniffing around
- Technology is past idea stage, has some heft to it, IP filings or prototypes.
- Grant or angel funding is in and provided value
- Founders are on board, part or most of the executive team is too
- A strong technical plan and tight milestones/objectives are in place
- Their money spent on proving / advancing the technology/IP, pulling together team, showing the market has interest and raising the next round
- Single digit raise, single digit pre money valuation post 20% ESOP

Anatomy of a B Round Deal

Typically a B round is raising c. 1-3x the A round investment amounts, with cash raised to last 2 years, and if a post first commercial ship deal, then c flat burn rate with capex/expenses growing roughly with or revenues, e.g. if revenues are not coming in according to plan, kick points in the budget so cash can still last 2 years. Note there is often a divergent at the B or C round between startups with capital and R&D intensive investment theses, and those headed to breakeven. Asking for 1 or <1x the A Round is generally a weak hand in a B round (successful startups tend to need more cash to fund growth at this stage), asking for >3-5x the last round is generally not credible (tends to beg the question why not do it in 2 steps rather than 1, aka maybe you're not as ready as you say?).

Expect 1-3 new investors, with 1-2 lead from the new investors.

B round investors tend to expect:

- First customers/revenues in the bag (some B rounds head down a bluesky R&D heavy path and FCS not seen til C or D rounds).
- Path to revenues, Revenue model and business model known, but not proven
- Technology to be proven, but not done
- Most of the permanent team onboard
- Their money to be spent on a combo of R&D and expansion (some BD, some mfg)
- Their money to enable the company to see breakeven, and possibly be ABLE to breakeven at the very end, but not breakeven without constraining growth

- A good plan to drive revenues, their money to go towards proving the business model
- Support from early customers/partners, R&D contracts, government funding leveraging their money
- Single to double digit raise, low to mid double digit valuation

When doing a B round it is useful to look forward and make sure the valuation, milestones, and time frames work for a C round as well. C round is generally raising 1-3x the B round, dilution is often sliding lower, venture or lease debt is sometimes more readily available than in the B, and cash burn rate targets can start to slip below two years as investors gain confidence in the predictability of future raises, or have a better handle on needed reserves for the investment.

C Round investors tend to expect

- A proven business and revenue model
- A range of customers on board and contracts
- The technology mature and product saleable
- The company's capital needs and burn to be flat to decelerating
- A plan to drive both revenues and margin
- Their money to go towards expansion, sales, and working capital
- Their money to achieve breakeven or an exit
- Beginning to see limited support from venture debt, expensive debt working capital financing, subsidized debt for expansions leveraging their money
- Uses of capital, c. 50/50 (mfg/sales and market expansion) / (R&D and overhead)
- Double digit raise, low to high double digit valuation

Prototypical revenue growth rate expectations from First Customer Ship:

- Can be binary, either mid 6 figures to low to mid 7 figures in first year revenues post FCS, the critical need in the plan is a credible first revenue year forecast to anchor the prospects. After the anchor point:
- Yr 2 1.5-3x Yr 1, backloaded,
- Yr 3 2-3x Yr 2, backloaded,
- Yr 4 2-3x Yr 3, backloaded
- Yr 5/6 2x prior

Highly capital intensive businesses in biotech, energy and a few other sectors often have specific variants on revenue growth.

Note, if you are selling the deal based on blue sky technology R&D, or based on customer pull/revenues, the trailing and near term revenues, the maturity of the revenue/business model and the product and amounts and uses of capital should align proportionately. E.g. nobody wants to buy a technology development story where their money is going to fund manufacturing and sales. And investors are leery of a commercialization/expansion story where too much money is going into R&D.

Valuation

Market sets valuation and terms, not company. Company proposes minimum conditions (be careful to propose market reasonable ones), negotiates terms sheet terms and valuation, and accepts /rejects the final. Note in smaller markets dominated by angel or microcap venture capital, this is less a truism, e.g. Australia, Canada, Norway, UK.

Given that one is hitting milestones and driving revenues in a hot market with a strong deal, expect dilution between 20-50% in B rounds, down from 40-60% in A rounds, and slightly lower still in C rounds.

Besides management strength, expect main driver of dilution and valuation levels to be: 1) level of interest in the space and size of the prize, 2) strength and support of existing investors, 3) the number of interested LEAD investors at the table, 4) the strength of external validation from trailing and NEAR term revenues, and external partnerships/customers. The financial fundamentals of the company and the technology tend to be less critical, as all deals that get funded usually have good ones, and the variability uncertainty factor in the key assumptions in the forecast is high.

Critical that the "ask" aligns actual performance to date, burn, cash needs and near term performance, valuation, relative ownership stakes etc. The "ask" involves: specifying $ amount raising, use of funds and key milestones to be achieved with the $, the % our existing investors are expected to take of the raise, post money and $ amount of the prior round, and chronology detailing milestones achieved since that valuation was set.

One can often see a paradoxical either / or that behaves like a momentum stock, where valuation is unanchored to revenues, earnings, or cashflow in the high burn years, or where the numbers are still low enough to be below a particular valuation breakpoint in that sector (Often market sectors appear to have M&A "breakpoints" in value below which companies in a given sector can purchase a technology with limited business as a cheaper buy vs build than the equivalent R&D spend, or where like biotech the commercialization path and synergies between technology and distribution are well proven).

However that same company can see valuation rapidly anchored to trailing/near term revenues or cashflow if momentum is lost. The "restart" phenomenon also suggests that same company can also deanchor again under the right conditions. High burn rate/high capex businesses are also suspiciously susceptible to this anchoring/deanchoring phenomenon. The squaring the circle on this paradox is growth, and investor confidence in the team, market, and other conditions that affect growth.

Timeline / Process

Prototypical timeline for a Series A-C investment is 12 months to close door to door measure from first investor contact to cash in the bank. Obviously some significant variability exists, but the prevalence of insider bridges at some point in a startups lifecycle even on many of the hottest, strongest deals suggest the timelines are a bit more set in stone that investors and management would like to believe.

We break the typical timeline up into 5 phases.

- Pre Market
- Round up
- Term Sheet
- Due Diligence
- Close

Of note our premarketing phase sometimes is done as part of normal course of business. It is our experience that deals without premarketing tend to take longer with less predictability.

Phase 1 Pre Market 3-5 months

- Meet and greet 30-40 investor meetings 6-9 months ahead of raise
- Sell the blue sky, the success to date hitting milestones, and
- Propose capital need as a range, anticipating tightening range once pre marketing indicates level of support likely
- Propose hittable milestones before the B is ready to market
- Triage investors into those that 1) have dry powder and 2) are already interested in your area and [3) will lead a round, OR 3) bring strategic value a name]. Be friendly but ignore all others.
- Soft circle triaged investors, maintain weekly contact at both board, founder, and management level.
- Build relationships, report on positive progress toward proposed milestones.
- During this phase need investment deck and story to start, will finalize deck and financing model. Prepare draft IM [IM never becomes final, always draft].
- Practice the hell out of the pitch internally.

Phase 2 Round up 3-4 months

- Go back to triaged investors.
- Need final financing model, cash need, and uses of capital.
- Need % anticipated to be taken by A round investors

- Need pitch deck
- Need friendly customers / partners ready to talk – external validation at your finger tips.
- Need technical deck for preliminary due diligence.
- Tell 8-15 investors they're on your list, and you'd like to discuss a term sheet. Target is getting 1-3 term sheets.
- Present to relationship investment partner, agree timeline for decision and term sheet.
- Organize meetings with other partners or present to full partnership
- Introduce them to full management team, board and investors.
- Agree list of due diligence items needed before terms sheet issuance.
- Schedule due diligence calls.
- Get term sheet. Celebrate.
- Note, many investors will NOT issue a term sheet that is not largely acceptable, and essentially issue a verbal or email "terms" in a socialization phase, and then issue an exploding term sheet only when they are reasonably confident you will accept.

Phase 3 Term Sheet 1-2 months

- Review term sheet with board. Evaluate whether it's "signable" as is or needs work.
- Get feedback from board, management, founders and legal on preferred revisions, critical ones, and bottom line on both terms and separately valuation/amount.
- Select single negotiator. Agree who negotiator reports to until negotiations are deemed final, eg, CEO, subcommittee, or full board. Negotiator handles all contact with investors relating to terms, all others refer any discussion to negotiator, but board and team maintains and builds working relationship broad with the new investor on non terms topics.
- Negotiator in daily contact and discussion, and reports daily to CEO/Subcommittee/board on progress issues.
- Expect that term sheet negotiations can add up 20-100% in valuation and equivalent relaxation in terms, everything's negotiable. Walk away from any term sheet that is not negotiable at all, but make it a win-win. Negotiate line by line. Have logic, data, counter proposals, and rationale reasons for every change.
- Expect to continue due diligence during negotiations.
- Expect 3-6 weeks of negotiations and 2 to 3 major and 4-5 minor turns on the term sheet.
- Shop term sheet while negotiating (most will contain no shops once signed). Attempt to secure 2nd and 3rd term sheet using existence, but not terms, of the term sheet as leverage to set a deadline. Talk up your prospective investor, not down, assume any investor who reaches term sheet stage is a good friend until proven otherwise, regardless of the initial terms.
- Identify investor prospects who might want to join a syndicate once the term sheet is signed.
- At end of this phase, we must sign a term sheet. Once signed, the real work starts.

Phase 4 Syndicate, Document, Final Due Diligence 1-3 months

- Take signed term sheet, and if additional investors are needed (lead and existing investors only committed partial funding), go back to existing targets and add new ones, and offer them a chance to join the term sheet.
- Deadlines are crucial here.
- Hand term sheet to counsel, begin drafting definitive agreements. Define review process, very easy to have too many cooks in the kitchen and cause unneeded problems.
- Expect first drafts within c 2 weeks, and expect minimum 3-4 turns of the documents before final. Documents should be close to term sheet, but significant negotiation will be needed on the language, and unclear portions of the term sheet, or areas where the term sheet was silent.
- Break negotiation in two, legal language, minor issues handled counsel to counsel, business issues and major divergences from the term sheet handled by original negotiators. Stay closely in contact and on the same page with lots of open communication so small issues don't become big ones.
- Expect review from not only board and counsel, but existing investors counsel as well, and counsel from syndicate partners, so turns will take longer. As with term sheet, 1 counsel should draft and negotiate, incorporating group's input each time.

Due Diligence

- IP, All legal contracts, background checks, and detailed customer diligence is done now. Any possible redflags should have been signaled before. Financial, general market/industry, and business model diligence should have been done by now.
- Company should have prepared "data room" for investor and counsel to review ready to go prior to signing term sheet.

Phase 5 Close – Days to Weeks

Everything should be done but exchanging final signatures and schedules, maybe a couple of conditions precedent, and wiring money.

A Few Points on Process

Standard practice involves no NDAs until a term sheet is signed. Financials, financial model, pitch deck, cap table, fairly deep technology overviews, product costs/prices, IP summary customer names, should be shareable pre NDA. Actual contracts, unpublished patents, detailed R&D plans, detailed customer pipeline may not, but it varies. However NDAs are more prevalent than investors typically admit, especially at later stages or on hot transactions where investors have a high confidence they intend to fund.

The most valuable asset in a fundraise is a term sheet, the faster to get one (even a bad one), the better the valuation. Many investors reject this concept, but it makes intuitive sense, this is a supply/demand for capital momentum driven market, not a fundamentals driven market.

Setting deadlines /ultimate for prospective investors is very dangerous and usually counterproductive, until any term sheet is signed, then deadlines can be powerful and productive.

A stale deal is a killer, never ask for the term sheet until you are comfortable you will get a yes, never show information to investors until they've been qualified.

Expect it's ok to ask for and get detailed information on their team, decision process, fund size/maturity, capital availability, existing competitive investments, references from their CEOs/other investors, and expectations on investment size, timing, valuation range, and board seat expectations.

Investors look at companies and technologies to invest in. They usually invest in "deals" and people, not technologies and companies (even if they say they invest in technologies and companies). They price based on competitive environment for your deal, not your financials or fundamentals. All deals that get funded look as good as yours at the time of funding. Ignore these paradoxes at your own risk.

Triaging/investor screening is critical. It's ok to kiss a lot of frogs and be very friendly, not ok to show them the deal or detailed information until qualified.

1) The only people who should get a full presentation are: decision level investment partners at venture funds with dry powder, who are interested in our sector and will lead a deal/issue a term sheet – or possibly more junior partner who is obviously interested in championing, but this tends to be a lower percentage path.
2) The only people who should get the financial model or an IM are, people who got a full presentation, and did a site visit, scheduled additional meetings, or otherwise expended resources showing they were interested.
3) The only people allowed to talk to customers, do real due diligence are: people who have done 1 and 2, expressed interest in leading and a time table, and signaled the amount they can invest and their preliminary thoughts on valuation.

Author

Neal M. Dikeman, is of Chairman of the Cleantech.org Network, and Chief Blogger of Cleantechblog.com. He has written for CNET/News.com, Cleantech.com, Sustainable Industries Magazine, and been cited in hundreds of media sources, and spoken at 100+ conferences on venture capital and energy tech.

He is currently Senior Venture Principal at Shell Technology Ventures, the corporate venture capital arm of Royal Dutch Shell, which he joined in 2013. Prior to joining Shell, he was a founding partner of Jane Capital Partners LLC, a clean tech merchant banking firm, since 2001. At Jane Capital he served as alternative energy and corporate venture advisor to a number of multinational energy companies including ConocoPhillips, Meridian Energy Ltd, and Macquarie Bank Ltd, and invested in, cofounded and was instrumental in launching multiple venture-backed alternative energy and technology startups including Smart Wire Grid, Inc., Carbonflow Corp, Zenergy Power plc (AIM:ZEN), Fideris, Inc., TriniTEQ Ltd, and Meridian Solar; serving in various capacities both as director and full time or acting executive.

From 2000 to 2001 Mr. Dikeman was Director of Business Development at Globalgate, Inc., an ecommerce technology venture firm, and the parent company of Yellowpages.com (later sold to SBC). From 1999 to 2000 he was an Associate at private equity fund manager Doyle & Boissiere LLC, which invested in mid-market manufacturing companies, including Ocean Pacific Apparel Corp.

Mr. Dikeman began his career in energy investment banking with Bankers Trust in the oil & gas and energy service sectors. He holds a B.A. from Texas A&M University, and has served on the board of a number of technology startups, currently including American Electric Technologies, Inc. (NASDAQ:AETI) and Greenhome.com.