

VENTURE CAPITAL INVESTING

THE COMPLETE
HANDBOOK FOR
INVESTING IN
SMALL PRIVATE
BUSINESSES FOR
OUTSTANDING
PROFITS

David Gladstone

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**The Complete Handbook
For Investing In Small Private Businesses
For Outstanding Profits**

David Gladstone



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**Dedicated to L.G.,
with love**



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PREFACE AND ACKNOWLEDGMENTS

After more than a decade in the venture capital investment business, I have not been able to find one book that covers the subject of venture capital investing in small private businesses. Many books, including my own **Venture Capital Handbook** from Prentice Hall, advise the entrepreneur on how to raise money from venture capitalists, but no book tells the whole story on how to invest in small private businesses. Although a number of books start out in that direction, almost all of them end in philosophical dialogue about small businesses and entrepreneurs.

The National Association of Small Business Investment Companies operates a school called the Venture Capital Institute. I have taught at that institute and know that it provides an excellent introduction to the venture capital investment process. One of the teaching aids at the institute is a large three-ring binder filled with articles by various faculty members. Each contributor has had extensive experience in venture capital investing, and each contribution is a gem in its own right. (For those interested in the institute, write NASBIC, 1156 15th Street, N.W., Washington, D.C., 20005.)

However, the institute's book lacks a uniform style and unifying theme. Like so many teaching manuals, it is great for teaching a group, but it does not suffice as a reference book. In addition, it is quite large and not portable. So, with pen in hand, I set out to write the definitive book on venture capital investing.

Venture Capital Investing is *not* the definitive book that I had hoped to write. I soon learned that one could easily write a ten-volume work on the subject of investing in small private businesses,

but that I would have to sacrifice comprehensiveness in the interest of size. Thus, this book should be considered a primer on venture capital investing. It will provide the reader with a good basic understanding of the subject.

Those who have been in the business for a while may find some of the material familiar and perhaps even too simple, whereas beginners may find it difficult. Whatever the case, there is abundant information here for all business people and investors who want to invest some of their money in venture capital situations.

If, after reading this book, you decide that venture capital investing is too difficult, there is some good news. An outstanding mutual fund that specializes in investing in small companies can do the work for you. It has an outstanding track record. You can get its annual report by writing to Allied Capital Corporation, 1666 K Street, N.W., Suite 901, Washington, D.C. 20006, or by calling (202) 331-1112.

Experience

After receiving my M.B.A., I thought I knew almost everything about business. After only a few months of working in the venture capital area, I realized how little I actually knew about the world of small business. Without question, the case book method that was pioneered by Harvard Business School is the best education that anyone can obtain before entering the venture capital investment business. But that training only gives you a "mind set" that enables you to approach each business problem as you would a case, and this makes it easier to solve venture capital business problems.

In reality, as many writers before me have observed, the classroom is far removed from the practical aspects of investing in small business. Venture capital investing is the last of the apprentice trades. One must be involved in the industry for a considerable length of time before one can expect to have enough knowledge to invest in the venture capital area. Up to now, the only way to develop this knowledge was through experience. This book represents an effort to remedy the situation - it is a reference guide that one can use again and again.

Over many years of investing in venture capital I have developed a system of approaching venture capital investing problems. Although the system is not foolproof, it has worked well for me all this time.

I have reviewed thousands of business plans using a methodology that has helped me avoid pitfalls and make astute investments. These methods of analyzing business plans are revealed in this book.

There are virtually hundreds of "tricks" to investing in the venture capital business. Many of them have been taught to me by my friends in the industry, others I have learned in the school of hard knocks. I have tried to pass on many of these small dos and don'ts of investing in the venture capital area in this book.

It is my sincere hope that the readers of this book will be able to avoid many of the disasters that can easily befall the investor who is putting capital into small business. With this book as a guide, an investor should be able to improve the odds of making a fortune by investing in a small growing business.

Acknowledgments

Many people have made this book possible - most of them are in the venture capital industry. It is important that some of them be given credit here. Obviously the mistakes and problems of this book are not theirs, but mine alone. I will forever be indebted to all the people who have taught me so much about the venture capital business. I hope that those whose names I don't mention will forgive my oversight.

Many employees at Allied Capital Corporation played an integral role in the outcome of this book. George C. Williams is indirectly, and perhaps even directly, responsible for this book because he has been teaching me about the venture capital business since 1973. Jon Ledecy and Brooks Browne have unknowingly played a large role because they challenged my assumptions on many occasions. Clyde Garrett, Cabell Williams, and Kathleen Ryan have played a similar role, and have also pointed out many critical aspects of small business lending.

Harry Brill has shown me how the numbers really stack up in a small business. David Parker's legal expertise has kept me out of trouble many times and taught me countless good lessons. Betsy Erickson helped me begin this book, Jane Drury finished it. To these two, I owe everlasting indebtedness. No words can ever thank them enough for all the help they gave.

Members of the Board of Directors of Allied Capital Corporation, all venture capitalists in their own right, have unknowingly contributed to this book. To the founding directors of Allied Capital Corporation - Curtis Steuart, Murray Toomey, Henry Kaufman, and Walter Green - I want to express my thanks for establishing the value system that has made Allied the strong company it is today. Those values are the cornerstone of this book. Special thanks go to Bob Long and Wallace Holladay, who joined the company later on and helped continue its growth. My deepest thanks go to three investors who came in about five years ago - Willem de Vogel, Ray Lee, and Joe Clorety, all of whom were willing

to risk their money at a time when Allied Capital Corporation was at a turning point. Not only did they invest their money, but they invested their time and attention to help the company grow even greater. The information they brought to the company appears in this book. To three later directors - Guy Steuart, William Walton and Warren Montouri - I say thank you for all the help you are giving me today.

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Capital For Business, Inc.
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My thanks to the many entrepreneurs who have suffered through my education in the venture capital business. God bless you all for all of your help.

A special apology is extended to women who read this book. Common usage of the English language provides for the use of masculine pronouns. The use of masculine pronouns is not meant to diminish the contributions of females nor to discourage females from becoming venture capital investors.

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CHAPTER 1

KEYS TO SUCCESSFUL INVESTING

Every person is the total of his or her experiences. Each of us brings to every situation intellectual "baggage" in the form of prejudices and preferences, inherited and learned from past experiences. Therefore, in order to understand what this book is about, the reader needs to know something about the background of the writer.

All of my experience with small business has come from my years at Allied Capital Corporation. Allied Capital has a lending group that lends only to small businesses and an investment group that invests only in small businesses. At Allied Capital, I have reviewed thousands of business proposals and I have met hundreds of entrepreneurs. While my formal knowledge of business comes from obtaining my M.B.A. from Harvard Business School, my practical knowledge of investing in small business comes from my experiences at Allied Capital Corporation. If you can understand the philosophy behind Allied Capital, you will understand this book's approach to venture capital investing.

Allied Capital Corporation

Allied Capital Corporation is a public company that was established in 1958. It went public on a best efforts offering in 1960 and raised \$1,000,000. I joined the company on January 2, 1974. At that time, it had four employees and about \$12,000,000 in assets. Since then, the company has increased its assets and earnings significantly. I would like to believe that Allied Capital's outstanding success has been due to my being with it, but in reality those

responsible for its growth are the many good associates who joined with me to build the firm.

Allied Capital Corporation has paid regular quarterly cash dividends and an annual extra cash dividend since 1964. The company's philosophy is that the stockholder must receive a tangible return every year. Since 1974, the company has increased its total cash dividend payout each year.

Allied Capital has a highly diversified investment portfolio. Over the years, the company has tried investing in just about everything. It has chosen not to concentrate on any one industry or any one stage of development of the companies it invests in. In recent years Allied Capital has not been seeking start-up companies, but it invests in a few of them every year. Nor does it seek to invest in turnaround companies (companies in trouble), although it sometimes get involved in them. Over the years, Allied's "bread and butter" has been of second- and third-round growth financings for existing businesses and leveraged buyouts of profitable companies.

It is interesting to note that Allied Capital has specialized in debt financings even with its equity arm. While the lending group at Allied Capital makes only small business loans, the venture capital group invests primarily in convertible debentures and loans with warrants. This debt orientation has been one of the reasons for Allied Capital's success and has permitted Allied to pay dividends each year.

As already mentioned, Allied has pursued a broad range of investments, from companies with mundane products to those offering high technology. However, the one type of company Allied seeks most aggressively is the "marketing-driven company." It constantly seeks companies that are driven to capture a share of the market.

If any readers would like an annual report of Allied Capital Corporation, they should write to Allied Capital Corporation, 1666 K Street, N.W., Suite 901, Washington, D.C., 20006, or call (202) 331-1112, and a copy will be sent. I hope that after reading this book you will be interested in becoming a stockholder of Allied Capital Corporation. If you would like more information in this area, see *Venture Capital Handbook* by David Gladstone, published by Prentice Hall.

WHAT ARE THE BASIC ITEMS TO LOOK FOR IN A BUSINESS PROPOSITION?

This book is about the "due diligence process." That is, it describes the steps that an investor should take in checking out an investment opportunity. This is a detailed process that takes weeks of work. It begins when an investor is confronted with a business proposal

and must decide whether the idea warrants further investigation. There are six critical components to look for in this first stage of evaluation.

1. The Numbers Should Be Properly Presented

Everybody in the investment business lives and dies by the "numbers." This means that the investor cannot proceed without accurate figures on a company's past performance. Anything less than accurate and detailed (and in most cases certified financial statements) will lead the investor into a business risk that is probably not worth the business opportunity. To repeat, no investor should make an investment without accurate figures.

In addition, **current** financial statements are an absolute must. All too often, investors are given old financial statements that are ancient history. The older numbers do not reflect how the company is doing now. You should not accept any statements older than three months. Make the entrepreneur give you current financial statements or don't invest. Any entrepreneur who sends you poorly prepared or stale financial statements does not deserve financing.

Another thing to look for is the entrepreneur's knowledge of the financials. You must make sure that your entrepreneur is able to explain the numbers in detail. If he can't, it is a sure sign that he does not live and die by the numbers and therefore will be a poor match for you because, as an investor, you must live and die by the numbers.

In addition, the entrepreneur must provide accurate and detailed projections for at least three years, but preferably five years. As an investor, you cannot assess how much money you can make without good projections. I remember asking an engineer for some projections on his small business and being told that he couldn't supply them because this involved "sheer speculation" and engineers don't guess about things; they only report what is known. Needless to say, I did not invest in his company. Projections are important because they reflect the company's financial plan. A company without a financial plan is a company without financial direction.

Another point is that if the company has not reached breakeven, it should provide you with a month-by-month financial analysis indicating when the company will reach breakeven. An investor needs to know when a company will finally reach cash flow breakeven and no longer need money.

If a small business person cannot produce accurate financial projections, it should hire an accountant to do so. However, if the entrepreneur does hire an accountant he should still know most of the numbers by memory if he intends to live and die by the

numbers. If you ask the small business person about the financials and he answers, "these financials were put together by my accountant" and cannot tell you why certain projections do certain things, the small business person does not understand the numbers. This is a clear sign that you will have problems in the future.

As an investor, I cannot afford to deal with entrepreneurs who do not understand the financial projections for their company. A good entrepreneur must know the operating plan and the financial plan. A good manager has a deep appreciation of accounting. He knows that without accurate and timely information he cannot manage his company. This sounds obvious, but many entrepreneurs are "concept people." An entrepreneur who lives by the numbers is the one you want to back.

2. The Deal Must Make Lots of Money

Usually one does not have to tell an entrepreneur that the projections must go up. Every set of projections that I have ever received from entrepreneurs go up. If they didn't go up, no one would be interested in investing.

Unless the projections go up significantly, then no venture capitalist is going to be interested in investing. Venture capitalists look for a return on investment of at least 25%, and in many situations they expect to see as high as 50% to 100% return on investment per year.

When you look at the projections, you should be asking, "What will the company be worth in three to five years?" Using that projection and the expected value of the company in three years, the investor should calculate how much of the company he will have to own in order to receive a high return on investment. If the projections don't go up significantly, the investor will have to own a very large share of the small business. Once doing this calculation, I determined that to make the type of return that I thought was commensurate with the risk, I would need to own 150% of the company. I didn't make the investment. It was a nice little business, but there was little possibility of a high return.

3. The Acid Test of a Deal Is Management, Management, Management

Some years ago I attended an industry seminar in which we were asked what attributes might indicate that a business was going to be successful. There were ten slots on the blackboard, and within a minute the first six slots were filled with the word **management**. Over and over again, venture capitalists say that the acid test of any deal is its management.

But what exactly does management mean? It is very easy for an investor to blame poor management for a loss, but the reverse is also true: One makes a lot of money when management is good. Well, then, what management qualities should an investor look for? Here are a few.

Honesty and Integrity. One criterion that every investor uses to test management is honesty. If the entrepreneur team is not honest, almost "honest to a fault," then it is unlikely that the lender or venture capitalist will invest. A friend of mine tells about touring a plant with a group of venture capitalists and stopping for a moment to watch a lady at a drill press. He happened to ask her what she was making. She replied, "Oh, nothing. I was hired just for the day. I was told there were some big shots coming through and that I should look real busy." Management's credibility (and that of others in the plant) was gone. As a result of that one incident, the company never raised the money it needed. The news of its actions went flying through the venture capital community and killed all hopes of raising cash.

Experience. Every lender and venture capitalist wants to back an entrepreneur who has extensive experience in the industry in which the business is operating. If the entrepreneur is a white-collar government worker who is going to buy a meat-packing plant, for example, the investor should have serious reservations about that person's qualifications for work in the industry. Would the entrepreneur know how to run a meat-packing plant? I remember one of the questions I asked a man who owned a meat-packing plant when I was fresh out of business school and filled with a new concept called "management by objective," or MBO. I asked the owner if he used MBO to run his plant. He was a fairly burly fellow puffing on a big cigar and he quickly informed me, "No, sonny, I don't use MBO in my plant. I use MBI." "Oh," I asked, "What is MBI?" To which this husky fellow replied, "Management by intimidation." This gruff entrepreneur knew how to work in his business. He knew that objectives were best left in the office and that management by objective would not work inside his meat-packing plant. He had the experience necessary to operate the plant.

Achievement. Solid achievements in the entrepreneur's background are a big plus. Every investor should look for achievements. The chances of success increase when the entrepreneur is an achiever. Look at the entrepreneur's background. What did he achieve in college? In business? Achievers are what make the world go round. During the 1950s, a social scientist studying achievers and