DAREK KLONOWSKI

THE VENTURE CAPITAL INVESTMENT PROCESS

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Preface

Venture capital and private equity investing is a fascinating field. It involves providing capital to private businesses with an aim to accelerate their development. It is a form of risk-equity investing, where private investors support firms with a combination of know-how and capital in order to exploit market opportunities. In examining the meaning of this type of investing, it is important to distinguish between venture capital and private equity. Private equity refers to the provision of capital to develop new products and technologies, to enhance working capital, to affect acquisitions, to resolve ownership and management issues, or to strengthen the balance sheet. Venture capital, on the other hand, refers to capital co-invested alongside entrepreneurs for the purposes of providing capital and know-how to early-stage firms. Consequently, venture capital is often regarded as a subset of private equity. To simplify matters, this book uses the term "venture capital" as its primary description of investing into private firms.

The completion of a successful venture capital or private equity deal requires the deal to progress through a multistage process. This process is challenging to investors, as they must face a number of unique internal and external challenges along the way. This book provides a unique and comprehensive description of this process. The mechanics of processing venture capital and private equity deals are captured in an eight-stage model, consisting of deal generation, initial screening, due diligence phase I and internal feedback, pre-approval completions, due diligence phase II and internal approvals, deal completion, monitoring, and exit. The proposed model has a number of unique features. First, the investment process is described from the fund manager's perspective. Each description offers an inside look into a venture capital and private equity fund and defines the various approval processes that investors must undertake in consultation with their internal approval bodies (namely, the investment committee and supervisory board) in order to complete the deal and exit. Second, the model highlights the level of internal documentation needed throughout the life of any investment. Third, the model provides a clear definition of the differences between the specific stages that occur during the evaluation of an investee firm. Fourth, the model defines the investment process in terms of three interrelated channels of activity: document channel, information channel, and decision channel. Finally, it highlights the multidisciplinary nature of venture capital and private equity investing, which draws from many fields including finance, business law, strategic management, human resources management, psychology, and sociology.

This book is organized according to chapter. Chapter one provides an overview of venture capital and private equity by describing its objectives, stages of financing, and the organization of a typical fund. It also offers an entrepreneur's perspective on venture capital and private equity. Chapter two focuses on an overview of the venture capital and private equity investment process and describes the eight-stage investment model. In addition, this chapter also highlights the importance of the process in defining the competitive structure of the industry, and develops a typology of venture capital and private equity firms in the context of the adopted investment process. Chapters three–ten offer comprehensive discussions of each of the investment stages, while chapter eleven focuses on the challenges faced by the venture capital and private equity industry in the new millennium.

In addition to the primary content, readers will find a number of special features throughout the text. Each chapter begins with a brief description of a venture capital or private equity firm from a different geographic market, including Western economies and emerging markets. The funds were chosen in such a way as to provide readers with an understanding that venture capital and private equity firms may come in different shapes and forms, rely on different investment philosophies and target markets, employ various types of specialists, and focus on different financing techniques. These vignettes highlight the many differences between industry players around the world by providing key parameters and statistics (such as capital under management, number of deals and exits, most widely recognized deals, names of founding partners, etc.). In addition, information is provided to illuminate the fund's investment focus, operating philosophy, geographic orientation, management and staffing, and so on.

Other special features include the Practitioner's Corner, which provides readers with hands-on, practical perspectives on specific operating issues that occur inside of a venture capital or private equity fund. The practitioners' overviews specifically focus on "ratchet" mechanisms and exit. International Perspectives in Venture Capital is another feature found within, and focuses on providing readers with some exposure to issues faced in emerging markets. Three unique challenges—related to privatization deals, simplified forecasting methodology, and auditing procedures—are described in this feature. Last, the book includes a feature called Corporate Governance in Venture Capital, which aims to highlight the existence of numerous corporate governance challenges in the venture capital and private equity industry. Topics of discussion include the industry's code of ethics and specific cases where such ethics may be applied.

In addition to the special features described earlier, the book includes a number of unique descriptions of the venture capital and private equity process. Some of the most unique topics covered include venture capital and private equity negotiations (the book focuses on the dynamics of venture capital and private equity negotiations, and captures the essence of "value exchange" between entrepreneurs and venture capitalists beyond a description of trading zones and opportunities), business analysis (the book provides a unique framework for analyzing the commercial attractiveness of deals based on the 5M principles and targeted financial analysis), and corporate governance (it focuses on issues related to corporate governance in the venture capital and private equity industry).

This project could not have been completed without generous assistance from numerous "stakeholders." I would like to acknowledge the invaluable contributions made by over 30 investment officers from some of the leading venture capital and private equity firms around the world. Their assistance has allowed me to create a comprehensive, homogenous overview of the venture capital and private equity investment process that reflects investment practices from different geographic regions. I would also like to thank Douglas Cumming from the Schulich School of Business at York University and Thomas Hellmann from the Sauder School of Business at the University of British Columbia for helpful comments on the draft proposal for this book; Kyle Lougheed for editorial assistance; Heather Johnston for allowing time off from Brandon University; Will Schmidt for insightful comments on investment committees; and Jerzy Strzelecki for discussing industry trends. Last, I would like to thank the staff of Macmillan, especially Laurie Harting, Heather Faulls, and Laura Lancaster as well as Rohini Krishnan from Newgen Imaging Systems, without whom this project could not have been completed.

Darek Klonowski

Kohlberg Kravis Roberts and Co.

Key characteristics

Year founded:	1976
Founding partners:	Henry R. Kravis and George R. Roberts
Number of limited partners:	N/A
Geographic coverage:	North America (5 locations), Europe (2), Asia (5), Australia (1)
Headquarter location:	New York (USA)
Focus (if any):	Leveraged buyouts
Funds under management:	$59.3 billion
Number of completed deals/ IPO exits:	165/N/A
Private/public:	Private/public*
Most publicly recognized deals:	Duracell, Safeway, Yellow Pages, Toys R Us, Shopper's Drug Mart, Sealy
Number of investment professionals:	~80

**Kohlberg Kravis Roberts and Co. (KKR) includes publicly held firms such as KKR Financial Holding LLC (NYSE New York: KFN) and KKR Private Equity Investors LP (Euronext Amsterdam: KPE).*

Kohlberg Kravis Roberts is one of the world's most widely recognized private equity firms and an expert in leveraged buyouts. It is a true industry leader, with nearly $60 billion under management. The firm is committed to 14 private equity funds.

KKR's investment philosophy is based on seeking out high quality investments with strong management teams, predictable cash flows, leading and defendable market positions, and superior growth prospects. Such an investment approach allows it to utilize its expertise in leveraged buyouts. KKR's landmark buyouts include some of the largest buyout transactions such as Energy Future Holdings ($48.8 billion), RJR Nabisco ($31.4 billion), and Alliance Boots (£12.4 billion).

KKR is known for its active role in assisting portfolio firms. Its staff of over 80 professionals includes many former CEOs and CFOs from some of the leading industrial firms. This strong pool of in-house operational talent allows the fund to make their investee firms more competitive and profitable.

The firm's owners, investment professionals, and senior executives have shown a strong commitment to building the firm's private equity business over the years. The parties have jointly committed approximately $1.9 billion to the business.

Source: *www.kkr.com.*

Contents

Chapter 1

Introduction

The development of new entrepreneurial ventures plays a key role in shaping any national economy. Entrepreneurial firms are a source of growth and innovation in the industry for owners and provide jobs for the local population. They are also believed to offset economic declines and help to restructure existing industry. A healthy entrepreneurial sector is critical to any national economy and imperative to economic growth for several reasons. First, it is estimated that six out of every ten jobs are created by entrepreneurial firms. Second, young firms are spearheading the industrial transformation from traditional industries into high technology sectors. Third, entrepreneurial firms are at the forefront of developing innovations with a clear competitive advantage; they are known to commit more capital and resources to research and development when compared with more established corporate entities. Last, entrepreneurial firms are making significant inroads in developing global markets.

Entrepreneurial firms face two major problems. The first concerns access to finance, which places particular constraint on a firm's ability to increase the level of technology in their business. The second concern is access to know-how. Newly established entrepreneurial firms with founders inexperienced in a commercial environment may posses multiple shortcomings with respect to their managerial skills and abilities, while young firms struggle to run their businesses. Most young entrepreneurial firms—even those with sizable operations and sales—may not employ functional specialists, especially in the areas of finance and accounting; consequently, they rarely prepare business plans or formal budgets.

Another department often neglected by inexperienced entrepreneurs is marketing and promotion. Additionally, there are two key moments in a firm's life cycle when "know-how" is required. In the early stages of development, beginner firms are often "virtual" in their development; there is only an idea, concept, or invention driving the ultimate development of a full business. The key problem to address at this stage of development is business survival. Firms at a later stage of development require a different type of assistance and support. The key issue for these firms is management of growth and expansion with an aim to ensuring the sustainability of the business in the long term and the successful transition of the firm to another stage of development.

The problems of access to finance and the provision of know-how are closely related: access to finance is necessary to address operational challenges, and effective managerial skills assure proper utilization of capital. The provision of capital without proper managerial assistance is likely to result in a lack of development for firms (lack of know-how often leads to limited investment, which, in turn, leads to the limited growth of the business), more sensitivity to external factors, and a business potential that is unlikely to be captured. Providing know-how without capital is likely to lead to the immediate downfall of the business, a "freeze" of the private initiative, and lack of propensity for taking business risk. In short, the unintended consequences of these two challenges can initiate a chain reaction leading to business failure.

The aforementioned problems can be addressed through the introduction of special types of investors called venture capitalists. Venture capitalists can resolve the dual problem of inadequate know-how and access to finance; they offer funding, technical and managerial support, and networking capabilities, and have become central to the development of entrepreneurial firms around the world. Venture capitalists not only support young entrepreneurial firms, they also provide their expertise and capital at different points in a firm's life cycle.

Definition of Venture Capital

Though its definition has evolved over the years, venture capital is generally defined as capital provided to private businesses aimed at accelerating a firm's development through access to capital and a wide range of business support services. The Webster's Dictionary defines "venture capital" as "a very risky investment." The Collins English Dictionary, defines venture capital as "capital for investment, which may easily be lost in risky projects, but also can provide high returns."

In examining the meaning of this type of investing, it is important to distinguish between industry terms that are used interchangeably, such as "venture capital" and "private equity." The European Private Equity and Venture Capital Association (EVCA) defines private equity as equity capital provided to firms not quoted on a stock exchange. This association further underlines that private equity can be used to develop new products and technologies, to support working capital needs, to make acquisitions, or to strengthen a company's balance sheet. It can also be used to deal with ownership and management issues. On the other hand, EVCA defines venture capital as capital co-invested alongside the entrepreneur for the purpose of providing capital and know-how to early-stage businesses (i.e., seed, start-up, or first stage of expansion). Venture capital is often regarded as a subset of private equity, referring more to investments made during the launch stages of a business.

The popularity of the term venture capital reflects the fact that in the early days of direct financial participation in private firms, early-stage firms received this type of financing. There are also geographical factors: North American investors used to prefer investing in early-stage firms (as confirmed by their investment into early-stage firms as a percentage of total investment); hence, their investments were increasingly regarded as venture capital. Comparatively, European investors historically pursued later-stage expansion deals; consequently, they preferred the term private equity.

To simplify matters, this book will use the term venture capital as its primary description of investing into private firms. Consequently, it will use the term "venture capitalist" (and not "private equity investor") to denote the manager of a venture capital or private equity firm who holds ultimate responsibility for the management of the fund's investments in specific firms and its portfolio of investee firms.

Venture capital can be most simply defined as risk-equity investing. It is an activity by which investors support firms with a combination of two important components—"know-how" and capital—in order to exploit market opportunities. Venture capitalists aim to achieve long-term, above-average returns.

Over the lifetime of a venture capital firm, venture capitalists aim to realize net returns on an entire portfolio of investee firms. These returns are expected to exceed the possible returns available from alternative investment possibilities (i.e., from the stock exchange). In fact, venture capitalists need to achieve above-average returns to justify the risks associated with young entrepreneurial firms, risky undertakings (i.e., new product development or expansion into an unknown geographic region), and the long periods of illiquidity inherent to venture capital investing. The strong returns expected by venture capitalists also need to cover the operating costs of the fund (from 1 to 2 percent of the value of the fund per annum, charged against the capital contributed by those institutions providing capital to the managers) and venture capitalists' own costs (which take the form of a carried interest). Since venture capitalists make long-term investments in the entrepreneurial firms they invest in, the aggregate value of their equity positions in these firms must significantly increase in order to provide net returns to limited partners (LPs). If a venture capitalist expects to achieve returns on an entire portfolio of firms in the range of 20–30 percent, any successes must also compensate for the underperforming firms and other additional costs. Each dollar invested in a portfolio of firms must multiply by 2.5 times in five years (the average holding period for venture capital firms) to achieve a compounded 20 percent rate of return, and by over 3.7 times to achieve a 30 percent compounded return. Table 1.1 presents a simple matrix describing the internal rate of return achievable under the assumption of the years spent holding the investment and the achieved cash-on-cash return.

Venture capitalists, who manage investments on behalf of LPs, have two constraints on their activities: time and money. To address the issue of an optimal allocation of time, venture capitalists generally attempt to focus their efforts on a specific industry, geographic region, or firms' stage of development. There are two investment models used. The first approach is based on the assumption that a careful evaluation of investment prospects (based on detailed deal negotiations, the preparation of comprehensive legal documents, countless revisions of the business plan, and the involvement of external experts) will result in fewer

Table 1.1 The internal rate of return (IRR) matrix expressed in percentages given the assumptions of the years holding the investment and the cash-on-cash return

Years	Cash-on-cash multiple								
	2x	2.5x	3x	3.5x	4x	5x	6x	8x	10x
2	41	58	73	87	100	124	145	183	216
3	26	36	44	52	59	71	82	100	115
4	19	26	32	37	41	50	57	68	78
5	15	20	25	28	32	38	43	52	58
6	12	16	20	23	26	31	35	41	47
7	10	14	17	20	22	26	29	35	39
8	09	12	15	17	19	22	25	30	33
9	08	11	13	15	17	20	22	26	29
10	07	10	12	13	15	17	20	23	26

investment mistakes and superior returns. Venture capital firms that subscribe to such an approach take their time and make fewer deals. On the other hand, there are venture capital firms that believe in the "laws of statistics," or the philosophy that certain deals will under-perform regardless of the amount of time spent on due diligence. Such firms also believe that writing comprehensive, all encompassing legal documents is counterproductive, as no legal documents will effectively save the deal if the investee firm proves unsuccessful. As a result, these venture capital firms complete more transactions. While there is no academic research to confirm which approach is superior, most venture capitalists appear to follow a "two-six-two" formula: two superior investments, six single-digit or no-return investments, and two write-offs.

Types of Financing for Firms

Firms generally rely upon two types of financing: internal and external. Internal sources of financing are limited, and can be generated by the firm itself. If the firm has been operating for some time and is profitable, it can support its own operations from internally generated cash flow. If the firm is unprofitable, it can manage its working capital in such a way that it is able to pay its liabilities on time. The firm can also invite its existing shareholders to contribute additional capital into the firm. In such a case, the existing shareholders would generally subscribe to new capital in proportion to their ownership stake in the firm (on a pro rata basis). The following section describes the most common types of financing.

First, firms can obtain financing by selling their shares in the stock exchange (through an initial public offering, an IPO, on the primary market, or through a subsequent offer of its shares in the secondary market). However, this is an option unavailable to most firms. Larger firms that have been operating for a few years and have a track record of growing sales and profits are ideal candidates for this type of financing. These firms are leaders in their respective marketplace seeking additional capital to expand their operations, acquire other firms in the sector, or develop new products. A founder's desire to realize profits (i.e., cash-out) or obtain high visibility in the marketplace through an IPO may also serve as a motivator to go public.

Second, firms can borrow capital from financial institutions (i.e., banks). Obtaining external finance from a bank is challenging—banks do not tolerate risk well. Contrary to general public opinion, banks may not be as friendly to business owners, particularly toward new firms that want to expand their products, build new facilities, or develop markets outside of their home market. The process of approving the loan is time consuming. In addition, banks require collateral that can exceed the value of the initial loan by two–three times. When firms get into financial troubles, banks are often quick to "pull the plug," or at best refer the troubled case to the bank's workout department (often located away from the local market, at the bank's headquarters), where the firm effectively becomes one of many nonperforming loans. From this pool of troubled loans, the bank tries to recover a certain percentage of funds, not necessarily being concerned about which firm the loan is recovered from. In many instances, the firm loses its relationship with a local banker, who initially approved the loan.

Third, equipment manufacturers and product suppliers may be willing to offer preferential payment terms to the firm. An extended payment term can effectively act as a substitute for a bank loan. While this is not a typical form of financing, many firms are able to manage their external relationships in such a way that they can effectively generate cash to support expansion. This facility may not be available to young firms.

Fourth, some firms operating in certain sectors of the economy can rely on preferential treatment from the government. This assistance may range from a direct payment to the firm to a reduction in taxes through preferential tax treatments (i.e., tax credits) or loans (often below a market rate). The nature of government-based programs, however, is that they are uncertain, limited, and politically driven; they are not sustainable for the government in the long term. In addition, it takes an extended period of time to apply for and subsequently receive the assistance.

Fifth, the firm can sell its shares to another firm (i.e., to a strategic investor from the same sector). While such a transaction does not create additional capital for the firm right away (since the acquirer only purchases an ownership stake in the firm), the new shareholder may be able to participate in subsequent capital increases. There is also the challenge of finding a new partner to assume an ownership stake in the business. Larger firms, for example, prefer to take a majority stake in a business, often leading to a lack of control for the founding entrepreneur.

Finally, there is venture capital.

The demand for these particular forms of financing depends on the firm's level of development, its profitability, the nature of the industry, investment programs, and the tolerance to risk shown by the providers of finance. While larger firms can generally take advantage of all financing options, smaller entrepreneurial firms have fewer opportunities. Table 1.2 summarizes the choices available to firms in various stages of development, and confirms that venture capital is perhaps the most flexible form of financing, though variations exist within different geographical markets.

Classic venture capital can be distinguished from other types of financing in several ways. Venture capital is equity oriented, which means that capital is usually provided in exchange for equity rather than debt. The most popular security held by venture capitalists is a convertible preferred share. A convertible preferred share is a hybrid security that combines the preferential protection of value offered by a preferred share with the upside potential offered by a common share. Venture capital is often subordinate to other types of financing and is not secured through any assets of the entrepreneurs or the investee firm. This means that venture capital has a lower priority of repayment in the event of problems. For example, if the investee firm becomes bankrupt, winds down its operations, is sold under distress, or experiences financial difficulties, venture capitalists may recover very little of or outright lose their entire investment.

Table 1.2 The possibility of financing through a variety of sources

	Early stages			Expansion stages		
	Seed	Start-up	First stage	Second stage	Third stage	Fourth stage
Demand for capital	Low	High	High	High/ medium	Medium	Low
Possibility of Financing by:						
Founder's capital	High	High	Medium	Low	Low	Low
Debt/bank loans	Low	Low	Low	Medium	High	High
Stock market	Low	Low	Medium	Medium	High	Low
Supplier/manufacturer credits	Low	Low	Low	Medium	High	Low
Government programs	High	High	High	Medium	Low	Low
Net profits	Low	Low	Low	High	High	High
Sale of shares/capital increase	Low	Low	Medium	High	High	High
Venture capital	Medium	High	High	High	High	Low

Venture capital is highly selective in its choice of investee firms. Traditionally, venture capitalists provide financing to one out of every one hundred business plans they review (venture capitalists need to review about five hundred business plans just to make five investments). This underscores a fundamental point that venture capitalists succeed by efficiently allocating the capital with which they have been entrusted among their investee firms. Consequently, it is not surprising that venture capitalists attempt to provide capital to firms that are highly profitable, have above-average future growth prospects, maintain a strong market share and significant competitive advantages over their rivals, and are led by a superior management team. On the other hand, venture capitalists tend to avoid firms requiring significant capital resources, competing in markets with dominant market players, and investing in small firms with commoditized products. The selective nature of venture capital investing aims to assure above-average returns while minimizing investment risk. To achieve this, venture capitalists methodically investigate each firm and its future prospects. The due diligence process takes weeks or months to complete and aims to address the risks associated with the business. Venture capital firms also make a medium to long-term commitment to their investee firms. Venture capitalists, on average, hold their investment for a period of three–five years, after which they seek to dispose of their shares. This holding period is normally synchronized with the firm's achievement of peak value and may be longer for young entrepreneurial firms that require more time to develop and grow.

Another important feature of venture capital is illiquidity. Venture capitalists participate in their investee firms, on average, for a period of three–five years. This time is dedicated to growing the business and achieving a suitable exit. The lack of liquidity is reflected in lower valuations of the businesses and a higher expected return to compensate venture capitalists for their inability to sell their holdings at just any point in the process (higher perceived risks mean higher discount rates applied when discounting the firm's stream of cash flows; higher discount rates translate into lower business valuations). A contractual agreement is drawn to assure a proper incubation period for the business, and the resulting illiquidity of the investment acts as a deterrent against venture capitalists' being opportunistic or having caprice to exit from an investment too early. Venture capitalists may be tempted to take such actions, especially during the fundraising period, when exit achievement is critical to raising new capital. The second motivator relates to how venture capital firms need capital to support their own operations and to be in a position to provide follow-on investments to existing portfolio firms. Some venture capital firms are precluded from using realized funds to put into other deals and support the cost of their current operations.

Venture capitalists make money from growth in the value of a business rather than through a pre-negotiated return with preset timing for the repayment of capital. Dividends are not normally paid out through the holding period and all profits are reinvested into the development of new products or services, the building of new production facilities, the acquisition of other businesses, or the strengthening of distribution capabilities. While normal return expectations in Western countries range from the high teens to low twenties over the holding period, these expectations double in emerging markets where the political, operational, and financial risks are higher. Venture capitalists normally try to achieve returns higher than those available in public markets to compensate for their high tolerance for risk and illiquidity.

Implicit in the definition of venture capital is a commitment to contribute more than capital to the process of working with a business. Venture capitalists have a degree of active involvement in the