



DR. TOM MCKASKILL



**Raising Angel & Venture
Capital Finance**



**AN ENTREPRENEUR'S
GUIDE TO SECURING
VENTURE FINANCE**

Angels and Venture Capital firms are in the business of generating a high rate of return on their investment, not in creating or building businesses.

To be successful, the investor needs to achieve an exit of their investment within three to five years and that means planning the exit strategy from day one.

The strategic trade sale is the preferred investment exit method.

The business plan sets out the operational detail of how the firm will create the necessary conditions for achieving the exit for the investor.

If you can't create the necessary platform for an Initial Public Offering, you are going to have to sell your business.

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Testimonials

‘Many entrepreneurs have achieved great success by partnering with Angel investors but they need to have the right business venture and the right approach to external investment to attract investors. This book provides the essential guide for anyone contemplating seeking Angel investment.’

– *John Mactaggart, Chairman Australian Association of Angel Investors*

‘Through his experiences as a successful startup entrepreneur, business school professor, advisor and author, Dr. McKaskill provides some great insights and a comprehensive game plan for companies seeking Angel and VC funding. Raising Angel & Venture Capital Finance is a great read for founders and entrepreneurs—whether they’re raising outside capital or just trying to understand the fundraising process—and just made our jobs as investors a lot easier.’

– *Joe Platnick, Partner iGlobe Treasury Management Ltd. and Director Pasadena Angels*

‘Tom is one of those unique individuals who has lived both a life of a successful entrepreneur and spent time understanding what makes them successful. This book is a synthesis of decades of this experience and is a must read for anyone who wishes to understand how to raise capital from the venture capital managers and angel investor.’

– *Richard Palmer, Investment Director, New Zealand Venture Investment Fund Limited*

‘An entrepreneur only gets a few chances to pitch a venture capital group. This book will prepare you and significantly enhance your opportunity to receive funding.’

– *Patrick Thean, President, Leadline Group, Inc., Charlotte, NC*

Testimonials

‘Early-stage investing is all about finding and nurturing a nugget of value with the goal of presenting the improved value for acquisition by a company in whose hands that value can continue to grow and reward. Investors need entrepreneurs who want to build and sell such companies. While they often share the same goal, investors and entrepreneurs frequently struggle to understand each others’ perspective. These are the myriad deals that don’t fail, they never happen because of a basic failure to communicate.

With his usual clarity, Tom explains the investor’s thinking to an entrepreneur and offers a practical guide to preparing for and pursuing such investors.’

– Jordan Green, Angel Investor and Deputy Chairman, Australian Association of Angel Investors Limited

‘Venture Capital is a highly specialised form of both business finance and partnership that relatively few people understand. Dr. McKaskill has provided a very useful introduction to the topic for aspiring entrepreneurs searching for the best ways to accelerate their business growth.’

– Doron Ben-Meir, Executive Director & CEO, Prescient Venture Capital, Melbourne, Australia

‘To stand out from the crowd, you must get into the mind of the venture capitalist, and understand their motivations and pressures. Raising Angel & Venture Capital Finance is a practical step-by-step guide that explains the pros and cons of raising and working with private equity and venture capital funds. This is particularly relevant in today’s market where both Debt and Equity are more difficult to obtain. Tom McKaskill’s first-hand experience in raising venture capital is a valuable resource for any entrepreneur or business owner.’

– Ian Knight, Partner, KPMG’s Corporate Finance Group, Australia

Testimonials

‘Tom has a wealth of entrepreneurial experience and he really understands how entrepreneurs do business. Every entrepreneur wants to know how to raise venture capital and Tom’s book is a “must read” for those that do. Tom’s book sets out exactly what is involved. It is essential reading for any entrepreneur.’

– Noel Lindsay, *Professor of Entrepreneurship and Commercialisation and Director of the Entrepreneurship, Commercialisation and Innovation Centre (ECIC), Faculty of Engineering, Computer and Mathematical Sciences, The University of Adelaide*

‘In addition to describing the current state of Angel and VC financing, this book provides entrepreneurs (and investors) with a very practical guide for designing businesses for growth. This book should be read by any serious entrepreneur who is even in the earliest stages of their new venture, such that they can lay down a solid foundation to enable later investment as needed. Later stage entrepreneurs can of course benefit greatly from this book and the many references it provides.’

– Martin J. Bliemel, *Lecturer, Australian School of Business, Strategy and Entrepreneurship, UNSW, Sydney, Australia*

‘Dr. McKaskill’s book is a great resource for entrepreneurs and investors. Especially part B of the book with investor ready indices and self-assessment guidance is very useful.’

– Peter Haubrich, *President, Okanagan Research & Innovation Centre ORIC, Canada*

‘Simple, straightforward and practical advice that speaks directly to the entrepreneur.’

– Michael Schaper, *former Professor of Entrepreneurship and former Small Business Commissioner for the ACT, Australia*

Testimonials

‘People in the business of building value have many competing priorities for their time. Raising external investment is often one of these priorities, yet even the jargon can take on a life of it’s own. Dr McKaskill puts the focus back on the important. The book contains approaches that puts founders, investors and advisors on the same map written in a common language. Building solid alignment is a core theme, so reading or re-reading this book is a great next step.’

– *Matt Yallop, Repertoire Management, New Zealand*

‘At the Australian Graduate School of Entrepreneurship we pride ourselves on the application of theory for practice sake. Our graduates are entrepreneurial, innovative and proactive, and enhance our reputation as the leader in entrepreneurship education in the southern hemisphere. Against this backdrop, we proudly integrate Tom’s e-books within our acclaimed Master of Entrepreneurship and Innovation program. The way in which Tom provides insights and applications in a logical, realistic and real-world way benefit not only entrepreneurship scholars, but anyone with an interest in high-growth ventures. Since entrepreneurs manage opportunities in a resource-scarce environment, raising angel and venture capital is most appropriately addressed by Dr McKaskill, an absolutely must read as a guide to securing venture finance.’

– *Dr Alex Maritz, Director: Master of Entrepreneurship and Innovation, Australian Graduate School of Entrepreneurship, Swinburne University of Technology, Victoria, Australia*

‘Angel and VC funds who invest together with entrepreneurs are entering into a joint venture partnership involving not only money, but expertise, networks and ultimately commercial success. Dr McKaskill succinctly describes the challenges and risks required to achieve a positive outcome for all parties in a balanced and straight forward manner.’

– *Greg Sitters, General Manager, Sparkbox Investments Limited, New Zealand*

Dr. Tom McKaskill



Global serial entrepreneur, consultant, educator and author, Dr. McKaskill has established a reputation for providing insights into how entrepreneurs start, develop and harvest their ventures. Acknowledged as the world's leading authority on exit strategies for high growth enterprises, Dr. McKaskill provides both real world experience with a professional educator's talent for explaining complex management problems that confront entrepreneurs. His talent for teaching executives and his pragmatic approach to management education has gained him a reputation as a popular speaker at conferences, workshops and seminars. His approaches to building sustainable, profitable ventures and to selling businesses at a significant premium, has gained him considerable respect within the entrepreneurial community.

Upon completing his doctorate at London Business School, Dr. McKaskill worked as a management consultant, later co-founding Pioneer Computer Systems in Northampton, UK. After being its President for 13 years, it was sold to Ross Systems Inc. During his tenure at Pioneer, the company grew from 3 to 160 people with offices in England, New Zealand and USA, raised venture capital, undertook two acquisitions and acquired over 2,000 customers. Following the sale of Pioneer to Ross Systems, Dr. McKaskill stayed with Ross for three years and then left to form another company, Distinction Software Inc. In 1997 Atlanta based Distinction raised \$US 2 million in venture capital and after five years, with a staff of 30, a subsidiary in New Zealand and distributors in five countries, was sold to Peoplesoft Inc. In 1994 Dr. McKaskill started a consulting business in Kansas which was successfully sold in the following year.

After a year as visiting Professor of International Business at Georgia State University, Dr. McKaskill was appointed Professor of Entrepreneurship at the Australian Graduate School of Entrepreneurship (AGSE) in June 2001. Professor McKaskill was the Academic Director of the Master of Entrepreneurship and Innovation program at AGSE for the following 5 years. In 2006 Dr. McKaskill was

appointed to the Richard Pratt Chair in Entrepreneurship at AGSE. Dr. McKaskill retired from Swinburne University in February 2008.

Dr. McKaskill is the author of eight books for entrepreneurs covering such topics as new venture growth, raising venture capital, selling a business, acquisitions strategy and angel investing. He conducts workshops and seminars on these topics for entrepreneurs around the world. He has conducted workshops and seminars for educational institutions, associations, private firms and public corporations, including KPMG, St George Bank, AMP, AICD and PWC. Dr. McKaskill is a successful columnist and writer for popular business magazines and entrepreneur portals.

To assist Angel and Venture Capital investors create strategic exits for their investee firms, Dr. McKaskill conducts seminars, workshops and individual strategy sessions for the investor and their investee management teams.

Dr. McKaskill completed three e-books for worldwide, royalty free distribution. He has also produced over 150 YouTube videos to assist entrepreneurs develop and exit their ventures.

Dr. McKaskill is a member of the Apollo 13 Angel Group located on the Gold Coast and a member of the Australian Association of Angel Investors.

Dr. Tom McKaskill



The Ultimate Deal 1

Selling your business

This book is aimed at those businesses which need to maximise their profit and growth opportunities in a sale to a financial buyer to leverage the best sales price. It sets out a breakthrough process which includes reducing risk, improving sustainable profits and building growth potential in the business to maximise the sales price. This world first process can increase the value of the business between two and ten times the conventional sales value of a firm.



The Ultimate Deal 2

Get an unbelievable price

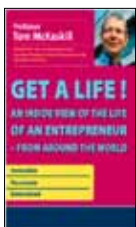
This book uncovers the secret of how to leverage strategic value in the business to create a large revenue opportunity for a strategic buyer. Dr. McKaskill's is the world's leading authority on selling a business to a strategic buyer and sets out a comprehensive and systematic process for selling a business to a large corporation. Sales values of 40 times EBIT and/or many times revenue are highly probable using his Strategic Sale Strategy for a business with underlying strategic assets or capabilities.



Angel Investing

Wealth creation through investments in entrepreneurial ventures

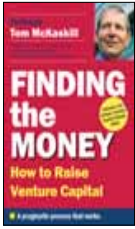
Designed to help high net worth individuals become successful Angel Investors. Angel investing involves active mentoring and coaching of an early stage management team towards sustainable profitability or additional funding, probably from a venture capital firm. This book sets out a comprehensive and rigorous process that will help the Angel generate deal flow, evaluate investment proposals and manage the investment and subsequent harvest. The book also provides a useful guide to managing operational risks in the venture.



Get A Life!

An inside view of the life of an entrepreneur - from around the world

This book is a collection of stories from entrepreneurs around the world where they describe their work and their lives. They explain what it is like to be an entrepreneur, how they got started, the successes and failures of their ventures and the highs and lows of their personal and business lives. The stories are rich in content and provide deep insights into how entrepreneurs think. If you are an entrepreneur this will resonate with your inner being. If you are not, this will provide you with a great understanding of entrepreneurs.



Finding the Money *How to raise venture capital*

The purpose of this book is to educate the entrepreneur on how Venture Capital firms work, what they seek in an investment and how they manage that investment through to an exit transaction. It helps the entrepreneur judge whether they have a venture suitable for VC investment and whether they wish to be part of such an activity. It lays out a comprehensive process that the entrepreneur can follow which will assist them in raising VC funding.



Winning Ventures *14 principals of high growth businesses*

Explains the major contributors to high growth success. Includes a comprehensive Growth Check list for each principle as well as a robust Growth Potential Index to help the reader judge the growth potential of their venture. Based on established theories of growth, venture capital selection criteria and the author's personal experience, this is a must for entrepreneurs.



Masterclass for Entrepreneurs

Creative solutions for resilience, growth and profitability

This book is a collection of published articles by Dr. Tom McKaskill. This volume expands on 30 of those articles to provide a wide-ranging guide for entrepreneurs on how they can manage their businesses more effectively.



Fast Forward

Acquisition strategies for entrepreneurs

In this book, Dr. McKaskill sets out a systematic and pragmatic process for identifying, evaluating, valuing and integrating financial and strategic acquisitions. He draws extensively on his own experiences as a CPA, entrepreneur and academic, as well as his experience with acquiring and selling his own businesses. He brings a systematic and comprehensive approach to growing business through acquisitions.



Raising Angel & Venture Capital Finance

An entrepreneur's guide to securing venture finance

This book is aimed at those entrepreneurs who have high growth potential ventures and seek to raise finance to assist them to develop their business. To secure the finance, the entrepreneur will have to demonstrate that their business is capable of achieving a premium on exit, usually through a strategic sale. The book provides a checklist for the entrepreneur to assist in developing a strategy to raise finance.



An Introduction to Angel Investing

A guide to investing in early stage entrepreneurial ventures

Designed to help high net worth individuals become successful Angel Investors. Angel investing involves active mentoring and coaching of an early stage management team towards sustainable profitability or additional funding, probably from a venture capital firm. This book sets out a comprehensive and rigorous process which will help the Angel generate deal flow, evaluate investment proposals and manage the investment and subsequent harvest. The book also provides a useful guide to managing operational risks in the venture.



Invest to Exit

A pragmatic strategy for Angel and Venture Capital investors

Investors in early stage ventures need to focus on strategic exits if they are to achieve a high return on their investments. This book explains the characteristics of strategic value, how the investor should negotiate the investment and then how they should manage the process to a strategic trade sale. The book includes a very detailed discussion on the problems of high growth ventures, the unrealistic expectations associated with IPOs and the advantages of investing in strategic value ventures.

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www.tommckaskill.com
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Preface

Few entrepreneurs succeed in raising Angel or Venture Capital finance. Many business owners don't bother to apply knowing that they won't be successful. Others simply don't need it and have an operation capable of generating the free cash flow they need to grow their business. Only a very few are able to meet the requirements of the Angel or Venture Capital (VC) fund and succeed in getting an injection of funds.

However, this type of funding is not a recipe for success. Around 50% of Angel investments are in ventures which fail. More than 20% of VC investments are written off and at least a further 20% fail to achieve their target returns. On the other hand, Angels and VC funds do succeed in picking winners and spectacular returns have been achieved in a limited number of deals.

Over the period 1978 to 1999, I was fortunate to have raised venture capital twice. The first time involved a software firm in the UK which I started in 1978 with two partners. By 1984, we recognised we needed to acquire one of our software suppliers to be able to control the direction of software development we were dependent on. We spent more than 12 months walking the streets of London looking for venture capital to finance the acquisition.

Eventually we were successful in raising US\$1.5 million for 20% of our equity from a corporate venture fund. A few years into the new structure, the business was in trouble. Our investor was acquired and our investment did not fit in with the investment objectives of the new owners. We were successful in buying back most of the shares of the VC fund for about US\$30,000. A few years later, with 160 employees, 16 distributors and more than 4,500 customers, we sold out to a US-listed software company for US\$9.6 million. Had the VC fund stayed in, it would have made a positive return on its money, although not the ROI it would have liked.

After working for the acquiring corporation in the US for three years, I formed a new firm, building supply chain optimisation software. We started with 12 people from the former firm which meant that we had a proven development team and proven management. After spending two years building the first modules of the new suite of products, a small company called Red Pepper sold

optimised scheduling software was purchased by Peoplesoft for something like 23 times revenue. Recognising that we were in a boom market we set out to raise venture capital.

This time I was wiser, with some prior success and a proven team. However, I still spent nine months going from VC fund to VC fund trying to raise US\$2 million. I discovered that the VC funds all specialised in industry, investment stage, size of deal and location. However, rather than miss out on the next Microsoft, they would still see you – just in case. Finally, we raised US\$2 million from a corporate venture capital fund for 20% of the equity.

Two years later, we had used up most of the money and had achieved little. The market proved much more difficult than we expected. The early indications of a boom market were not realised and several firms in the sector were in trouble. SAP, the world's largest application software provider, then announced a full suite of products in our sector, quickly followed by similar announcements by their major competitors. Most of these products were 'in development'.

Soon our prospects had essentially disappeared. We were faced with dramatically reducing the size of the business or selling out. We decided to sell out. Within a few weeks we had eight firms interested in buying and a week later received an offer from Peoplesoft at six times revenue. The VC fund came out in front with a reasonable return.

When I returned to Australia in 2001, I was appointed Professor of Entrepreneurship at the Australian Graduate School of Entrepreneurship. Over the next few years I had time to reflect back over 20 years' experience as an entrepreneur over four different ventures. I also had the opportunity of working with many start-up ventures and with several venture capital firms. Certainly, in the past 30 years, the venture capital market has matured. There are now many Venture Capital Funds or General Partners in the US, UK and Australia with many investments to their credit. We all now have a much better idea of what it takes for a new venture to be successful, although we still don't have the secret to success.

More recently I have become active in an Angel Group and have been involved in educating Angels on selecting and exiting investments. One thing which is now very clear to me is that the objectives of the Angel and VC fund are rarely the same as the entrepreneur seeking venture capital. It is only when the entrepreneur

understands that he or she has to tailor the venture to meet the requirements of the investor, and not the other way around, that the parties have a real chance of succeeding.

The objective of this book is to show the entrepreneur how they can create a business which matches the investment objectives of the Angel or VC fund. In doing so, there is a high probability of raising finance. Venture capital is not for everyone no matter how profitable the venture might be. Angels and VC funds are not in the business of solving an entrepreneur's need for funding albeit that may be the outcome. They are simply there to achieve a high rate of return for themselves, their investors or limited investment partners. The entrepreneur who understands this and builds a proposal to meet their objectives, should be much more successful in gaining Angel or Venture Capital finance.

Tom McKaskill

Acknowledgements

A very large number of people have contributed to my knowledge of this topic. Hundreds of entrepreneurs who have been through my classes and workshops, Angels who have attended my training sessions and discussed their investee firms with me and VC executives I have worked with on exit strategies for their investee firms. Each conversation, question and problem has helped me refine my knowledge of Angel and VC finance.

My life partner, Katalin Johnson, has been with me every step of the way, participated in the seminars, workshops and most of the conversations. She has assisted me greatly by asking the hard questions, reviewing the material and making her own contribution to the content.

Tom McKaskill
Australia
August 2009

info@tommckaskill.com
www.tommckaskill.com

PART A

Angel and Venture Capital Investment

A Wealth Creation Partnership

Every entrepreneur I know expects to build a winning business. Whether it is the business they have right now or the next one they have in their plans, they hope, one day, to get it right. They are optimists. Fortunately for all of us, they are prepared to risk their savings and their time to have a go because without their drive, creativity and perseverance, many of today's large corporations would not be in existence.

One could also say the same about Angel and Venture Capital funding. Without their funding and active involvement, many of the successful companies of today would have floundered. This partnership between entrepreneurs and private equity capital has created significant wealth for both parties and, along the way, many jobs, new innovative products and a major source of export earnings. However, it is a very small part of overall private enterprise capital and the chances of a successful outcome are only fair.

Because of all the public relations and hype around venture capital, we are left with the impression that it is a major contributor to business growth and job creation but the truth is that it is relatively insignificant in overall terms. Only about 1 in 10,000 private firms will have independent private equity at any point in time and only about 1 in 20 firms seeking external private equity will be successful in receiving it. So why is it seen to be an important factor in business development?

The answer is found in the role that private equity plays in early stage, high growth ventures. To appreciate that role, we must first understand what it is and how it works.

There are various forms of independent private equity. Angels typically provide finance for very immature ventures. Formal Venture Capital funds tend to undertake deals in the business expansion to late stage of venture development. The large Private Equity funds invest in mature businesses which are undertaking a reorganization through a management buyout or are aiming for a public listing. Even the terminology is somewhat confusing. In some markets the term venture capital refers to any independent private equity investment, especially from investment funds, while in others the term refers to different types of investment. In more established markets, such as the USA, Venture Capital refers to seed, early stage and some expansion capital, while Private Equity normally refers to late stage, mezzanine, buy out and management buy out or leveraged larger scale investments.

Collectively the term Private Equity (PE) can be used to cover all forms of independent investments. In this book, the term Venture Capital (VC) will be used to refer to the form of private equity most often raised by emerging enterprises, that is, those seeking funds from business Angels or Venture Capital Funds to develop their business concept or to support the initial growth phase.

The common feature of VC investments is that they provide business finance in relatively high risk situations where other forms of finance, such as bank loans or lines of credit are not available. Because there is a high risk, high reward element in these deals, there are both significant failures as well as spectacular successes. It is mostly the long term successes which give the VC sector its reputation.

Private equity fills a gap in the market of business finance, however, it is very focused and, therefore, the vast majority of businesses do not satisfy the investment criteria. Private equity investors are seeking opportunities for returns well above what an average public equity investment would achieve. They accept that the investment will be tied up for some time and the venture they are investing in is of a somewhat risky nature. They look for investments

which have the potential for very high rewards. These ventures will always have a high growth potential component. That, in itself, means these ventures are unusual as only a very small percentage of businesses ever succeed in reaching a few million dollars in revenue.

To generate a high return, let's say in excess of 20% per annum, the venture has to have the possibility of generating high revenue growth or creating significant strategic value. This potential exists in only a very small percentage of early stage businesses. The vast majority of high growth potential ventures are unable to inherently generate enough cash to fuel their business development plans, thus creating the opportunity for private equity investors to participate. Without private equity, most of these ventures would fail or never realize their potential.

This is the genesis of the entrepreneur/private equity partnership. These two parties come together to create something which neither could do by themselves. In doing so, they have the opportunity of creating a business venture which can generate significant rewards for both. This is the place where the entrepreneur accepts that a small part of a larger pie is better than no pie at all or a much smaller pie which is not getting bigger. It is also a place where the parties have to work together to be successful. As we will see in later chapters, that is not without its challenges as these ventures tend to push the envelope and risks, disruptions, delays and surprises are the norm rather than the exception.

The Private Equity market is much misunderstood by the average entrepreneur. They have little understanding of the structure of the private equity market and tend to see it as one size fits all - 'Venture Capital' without appreciating the different forms of private equity. Most start-up entrepreneurs see Venture Capital as the solution to all their problems. Venture Capital it seems is simply there for the taking - if only they can have those few minutes to pitch their groundbreaking idea. The limitations of lack of experience, a yet to be completed product in a yet to be proven market seem to be small hurdles which the venture capital firm can surely solve for them. However, few really understand how these funds work and very few understand the impact that taking the money will have on themselves, their businesses or their future.

Most entrepreneurs seek VC to solve a funding problem. They seem to think

that the purpose of VC is to solve their problems, whatever they might be, and that access to money is the key to success. Almost as if throwing money at their great idea will solve any basic flaws in the idea. In high growth firms there are usually lots of constraints to growing the business and lots of places where additional funds could be usefully directed. This might be to complete a research project, launch a new product into the market, build out an executive team, expand the capacity of the business or its market presence and so on. In their quest for Angel or VC finance, the entrepreneur often thinks that by solving their own problems they will automatically provide a good investment for the VC investor.

However, few have ever thought of the specific needs of the Investor and what they want out of the investment or what limitations, constraints and motivations they work under. While they understand that the return sought by Investors is higher than say a bank, they have little appreciation of the risks that Investors take and how they manage those risks or what this means in terms of how they judge applicants or negotiate the investment agreement. Successful entrepreneurs who have taken a business to an IPO or made substantial personal wealth through an Angel or VC backed venture often only experience the good times and are more than willing to recommend this form of equity finance. However, a portion of Angel and VC backed ventures fail or end in disappointment for both the entrepreneur and the Investor. Investors anticipate some level of failure and manage their investee firms accordingly as they have learnt over time to take a hands-on approach to their investments.

Entrepreneurs who have raised Angel or VC funds have often been confronted with a whole range of issues which they have not experienced before, or were not expecting. Often to the surprise of the founder, the Investor insists on a formal Board, a say in the strategy, a veto over certain operating decisions and regular financial and operational reports. In addition, the investment agreement or shareholders agreement may contain clauses which mean that, in certain circumstances, the entrepreneur can be dismissed and their business sold from under them.

This all sounds very painful for the entrepreneur – so why bother? What is missing in this scenario is an educated entrepreneur who understands how Angel or VC finance works and how to optimise the use of such funding so that the entrepreneur can achieve his or her objectives alongside those of the Investor. Angels and VC firms play a very important role in the structure of venture

funding – but it has a limited role and is really only appropriate for certain types of situations and certain types of endeavours. But for those which can meet the requirements of the Investor and understand how to leverage the relationship, it can provide a platform for wealth creation unparalleled by any other form of finance. Many successful entrepreneurs have launched lifelong careers in high growth enterprises through their first Angel or VC backed venture.

Perhaps the least understood aspect of Angel and VC finance is the need for an exit event for the investor. There are basically two types of Angel and VC backed ventures; financial and strategic. The financial venture will strive for high growth in revenue and profit and will exhaust the supply of cash to drive growth. On the other hand, a venture which creates strategic value will use whatever cash is available to build an asset or capability which will be attractive to a large corporation. Both these ventures eat cash and rarely throw off spare cash to pay dividends to the investors. In fact, Investors assume this will be the case and understand that they will only see a return of their original investment and a profit on the activity when the business is able to achieve an 'exit' event.

In the case of a financial venture that would be an Initial Public Offering (IPO), achieved by only a very small percentage of investee firms, or a financial trade sale. Strategic ventures generate a return to the investors by being acquired by a large corporation in a trade sale. VC investments are often called 'patient capital' simply because they have to wait for the venture to achieve one of these exit outcomes.

The need for an exit event is fundamental to an Angel or VC investment. It is the only practical manner in which the investor will achieve a return of their investment and a profit from the transaction. Given the critical nature of the exit, it is the most important characteristic of the decision to invest and the highest priority aspect of the business development strategy. It also means that an entrepreneur who seeks equity finance needs to accept that his or her venture will be directed towards an exit as a condition of the investment. With the exception of the rarely achieved IPO, this means the business will be sold in a trade sale within a few years of the investment.

Almost without exception, a trade sale will see the end of the business as an independent entity and, almost certainly, the senior management team will exit

at the same time. While this may seem like the end of the grand adventure, it really is the start of a new one. The cashed up entrepreneur achieves a reward for their creativity, energy and innovation and has the chance to do it again, retire, become an Angel investor or become active in philanthropy. Not a bad outcome for their contribution. One journey finishes and another starts, but they do need to accept that by taking the funds, the likely outcome will be that this baby will grow up and go its own way.

With a greater appreciation for how Angel and VC finance works, the entrepreneur can decide if they want to take this path to wealth creation. It is not without its challenges but it a path worth exploring if the underlying venture has the potential.

The purpose of this book is to help the entrepreneur decide if this is the right path for them. It seeks to educate the entrepreneur on how Angel and VC finance works, what the Investor seeks in an investment and how they manage that investment through to an exit transaction. It will help the entrepreneur to judge whether they have a venture suitable for investment and whether they wish to be part of such an activity. It also lays out a comprehensive process which the entrepreneur can follow that will assist them in raising Angel and VC funding.

2

Sources of Private Equity

Private Equity comes in various forms and generally depends on the stage of development of the investee firm. Knowing the extent to which the business has matured is often an indication of the risks the business faces and the type of support it needs to get to the next stage.

The Australian Bureau of Statistics' 2001 Special Article – Venture Capital Survey uses a multiple stage classification to describe business maturity. The definitions describe stages at which Angel or Venture Capital finance is invested.

- **Seed:** product is in development. Usually in business less than 18 months.
- **Early:** product in pilot production. Usually in business less than 30 months.
- **Expansion:** product in market. Significant revenue growth.
- **Turnaround:** current products stagnant. Financing provided to a company at a time of operational or financial difficulty.
- **Late:** new product or product improvement. Continue revenue growth.
- **Buy out:** [leveraged buy out (LBO), management buy out (MBO) or management buy in (MBI)]: a fund investment strategy involving the acquisition of a product or business, from either a public or private company, utilising a significant amount of debt.

Source: ABS, 2001, Special article - Venture capital survey

A similar classification is provided by the British Venture Capital Association. In their case investments in private companies are classified by the stage at which the funding is needed. Stage definitions are:

Seed Stage	Financing provided to research, assess and develop an initial concept before a business has reached a start-up phase.
Start-Up Stage	Financing for product development and initial marketing. Companies may be in the process of being set up or may have been in business for a short time, but have not sold their products commercially and are yet to generate a profit.
Expansion Stage	Financing for growth and expansion of the company which is breaking even or trading profitably. Capital may be used to finance increased production capacity, market or product development, and/or to provide additional working capital.
Replacement Capital	Purchase of shares from another investor or to reduce gearing via the refinancing of debt.
Buy out	The acquisition of a significant portion, majority control or 100% of businesses which normally entails a change of ownership. Funds are often used for expansion, consolidations, turn-arounds, and spinouts of divisions or subsidiaries.

Source: <http://www.evca.com> Accessed 29/12/04

There are only a limited number of Venture Capital funds focused on financing seed or start-up stages, although this is often the stage where Business Angels play a major role.

An emerging company which has constructed an experienced management team, a robust competitive position and strong gross margins usually has little need for Angel or VC investment. Early stage ventures with strong profit and high growth potential may be able to skip Angel financing and go direct to formal venture capital. The Angel plays the middle role: funding the business that has yet to stand on its own feet and not yet mature enough or with enough potential to attract venture capital. Angels typically invest in seed, start-up or early stage businesses.

Angels often play the financing role between 'family, friends and fools', often referred to as 'close money' and formal venture capital. Coping with what has come before and what comes after their involvement in the venture is a challenge for the Angel. On the one hand, Angels need to develop the business given the

constraints inherited from earlier investors and then they need to prepare the business for the next round of investment, usually from formal venture capital. Even though the majority of their investee firms will not require venture capital, this will not always be apparent in the early stages of the Angel's involvement with the investee firm.

Business Angel finance, the role of the Angel and the manner in which Angels work will be covered in greater detail in the next chapter.

Family, Friends and Fools

Most new firms start with whatever funds the new enterprise team can scrape up between them. This may be advances on credit cards, savings and bank loans (generally secured on property). This is the entrepreneur's money and if they lose it, they have only themselves to worry about. Most ventures start this way and may never require further shareholder investment. The profits are normally re-invested to fund additional working capital as the business expands, however, funds for expansion are often limited as the founding team usually exhaust their personal savings. To keep the enterprise going and to fund the next stage of development, founders normally turn to their family and friends.

However, everything has a price and even money from those who are close comes with its own problems. While they may not have the same ROI requirements as an Angel or be subject to the regulations and timescales of the VC, investment from family and friends (close money) has its own issues. Fools are said to be investors who throw their money in on the off chance that it might make a return, but generally don't risk very much and have low expectations of getting the money back.

New ventures are not without their risks. Australian research indicates that up to 70% of new start-ups will fail within five years. Further, few will ever grow beyond six people and very few will achieve significant size. The chance of losing the money from relatives and friends is reasonably high.

One of the considerations which new venture entrepreneurs face is the impact on their relationships with family and friends of the venture failing.

What happens when the venture fails and close relatives have invested life savings into the business, having been sold on the dream of owning part of the next Microsoft? Few non-business people really appreciate the risks of a start-up. Everything appears attractive up-front when it all looks so easy and they are sold on the idea of their young relative growing a monster company. But when it fails and they accept that their relative simply didn't have the experience to make it work, will they really be happy to write off the investment, or will this be a lifelong problem between them?

The same could be said of close friends. Being work colleagues, school friends or social friends hardly qualifies people to undertake the stress and rigor of going into business together. What happens when their talent and experience proves not to be the level required, they don't really want to put in the time or they want to have the final say on all decisions? Then there is the dysfunctional team which may cause the failure of the venture or may need to be broken up by forcing some of the team to quit. If they have money invested in the venture and still own equity, how are the remaining shareholders going to buy them out or deal with their ongoing equity interest?

Many start-ups involve couples, business colleagues, school friends and relatives. Not all of them will appreciate the time and effort which must be put into the venture to get it to a reasonably profitable, sustainable state. There are many stories of partners working long hours, taking low salaries and undertaking activities they are not trained for just to survive. Not everyone going into the venture is capable or willing to put in the effort and time it takes to get something up and running.

Close money may or may not come with other constraints. If a founding investor is working in the business, they may well feel an equal partner and want to be actively involved in the decision-making on a day-to-day basis. While this can work in very small firms, it becomes very problematic as the firm grows. As more staff join and the firm becomes more complex, some formal organisational structure is required. At this point, the question of who is boss and who makes the decisions becomes a real issue of debate and often conflict. With independent people, this can be more easily resolved; however, when the other person is a spouse, cousin or best friend, the issue is not so readily resolved.

At the same time, family investors who don't work in the business may feel a need to interfere if they see something they disagree with, even without understanding the situation or the business requirements. So the wife of the cousin who sees differentials in remuneration or different workloads may feel compelled to voice criticism to the aunts and uncles. Now the managers are spending time defending their actions to people outside the firm who may have no idea of the pressures they are under.

Then there is always the issue of a family member, friend or fool who decides that they would like their investment capital back before the other shareholders are ready to exit the business.

An issue common to many new ventures owned by married couples are the problems which arise when they start a family or go through a divorce. Where other owner/managers are involved in the business and one needs to take time out for family reasons, this can create tension and assertions of unfairness and inequality. Where a divorce occurs, it may be impossible to continue a close working relationship. The issue of ownership and involvement can become a very messy problem, often resulting in the failure or sale of the firm.

A major consideration for the entrepreneur is what happens to the original team as the firm grows. Will they be capable of playing their part in the management team of a firm which grows to 30, 100 or 500 people? If they don't have the experience, personality or capability to handle the tasks, how will the problem be resolved?

Investors are often confronted with these complex personnel situations. As an external and perhaps a more objective investor, the Investor needs to tread carefully around these relationships. Clearly, if they don't see that a constructive business environment exists, or one that can be readily resolved through discussion and a realignment of roles, responsibilities, remuneration and objective decision-making processes, they are better off rejecting the investment. If the Investor thinks the team is not capable of delivering the growth and profit required, they will simply walk away from the investment opportunity. If there is a problem between founders and early investors and the Investor feels that this will limit the process of building the business, then they are better off not investing.

At the same time, the Investor needs to acknowledge that the venture probably would never have survived had it not been for the investment, time and commitment of those people who were willing to come in at the start. This is an interesting problem for the Investor to deal with.

Before proceeding to invest, the Investor must be satisfied on the following issues:

Will the family, friends and fools interfere in the negotiation for the investment, the management of the company or the decision on the exit strategy?

Do the family and friends who helped start and grow the company form part of a management team? Does the investor have confidence in them and is he willing to trust them to grow the business to achieve its potential?

Current management and shareholders should be aware that these issues will need to be addressed as part of the investment agreement. The Investor may require that some of these problems be resolved as part of the decision to invest. This may involve a restructuring of the business, new job descriptions and a more formal organisation structure. The Investor might also be willing to buy out some of the early shareholders in order to simplify the shareholdings.

Venture Capital Funds

Venture Capital is the most formalised form of private equity investment. Unlike most Angel investments where the Angel takes a personal role in deal due diligence and management, Venture Capital provides a channel whereby high net-worth investors can participate in higher risk ventures without having to personally undertake the burden of venture evaluation and management. The VC fund itself provides the expertise in sourcing, evaluating, investing, managing and harvesting the venture investments.

Whereas most Angels invest in their own right, VC investment is through a fund. The common structure of a Private Equity Fund or Venture Capital

Fund is the Limited Partnership. This structure is commonplace in both the USA and UK markets and has been introduced in Australia. The benefit of this structure is that the fund itself is not a legal entity for tax purposes for the investor. There is a pass through treatment of any gains for tax purposes. Thus any gains and losses pass directly to the investor and are taxed in their hands. The investor also has the benefit of limited liability at the level of the fund itself. No liability from the investee firms can pass back to the investor. A comprehensive description of the Limited Partnership Agreement can be found on the British Venture Capital Association website (see www.bvca.co.uk/).

Funds are normally closed-end in structure, meaning that the investor has very limited or no ability to withdraw their investment during the fund's life. Funds are typically established for a 10-year life, but may be extended in some circumstances. The investor (also known as a Limited Partner) commits to make available funds as needed for the underlying venture investments. Investments are then normally made by the Investment Manager (otherwise called a General Partner) generally over the first one to five years of the fund life. As investments are harvested, proceeds are returned to the Limited Partners and not re-invested into new opportunities. Since the timing of exits cannot be known in advance, Limited Partners must be prepared to wait for some time before they start to see any return on their funds.

In his book, 'Early Exits: Exit Strategies for Entrepreneurs and Angel Investors (But Maybe Not Venture Capitalists)' Basil Peters notes the following:

Most VC funds are designed for a lifetime of 10 years. But in practice, the actual lifetime of technology (IT) VC funds averages closer to 13-14 years.

Limited Partners typically give a wide degree of discretion to the General Partner to invest on their behalf as they cannot know before the fund starts to operate the types of investments which may present themselves. The fund

agreement typically specifies the minimum and maximum investments the fund can make in any one venture. The Limited Partners are committed to the investments made by the General Partner and there is generally no ability for the Limited Partner to withdraw from any investment made by the General Partner. Typically, General Partners or Fund Managers issue a Prospectus or Information Memorandum to investors to raise their investment capital.

The typical Private Equity Fund terms are:

Minimum investor commitment	Often \$5 million or greater.
Manager's commitment	General Partners typically invest their own money in the fund. Often this will be around 1% of the total fund and is sometimes a prerequisite of the Limited Partners.
Partnership term	The fund life is normally 7-10 years with the possibility of limited extensions to facilitate exits. Distributions may be made as investments are sold.
Investment/commitment period	On average, Private Equity Funds invest committed capital over a 3-5 year period.
Management fees	Normally the management fee is set between 1.5% and 2% of committed capital.
Incentive/performance fees	Typically 20% of the total returns and is usually only paid once the Limited Partners achieve a predetermined hurdle rate. This is known as the 'carried interest'.
Preferred return or hurdle rate	The carried interest may not be paid out until total returns exceed some agreed threshold. Currently (2004) this is around 8%.

Source: <http://www.evca.com> Accessed 27/10/03

A comprehensive glossary of phrases commonly used within the Australian Venture Capital Industry can be found on the AVCAL website.

Source: <http://www.avcal.com.au>

In Australia, The venture capital sector is relatively small but is growing. As at 30 June 2005, the industry had the following characteristics:

- Number of venture capital managers 140
- Number of venture capital vehicles 210
- Number of investee companies 912
- Venture capital under management A\$11.2 billion
- Venture capital invested for the year
ended 30 June 2005 A\$0.839 billion

Source: ABS 5678.0 Venture Capital 2004-5

By the time of the 2007/8 ABS survey, the number of active Venture Capital and later stage Private Equity managers has increased to 183 managing 286 ventures.

Source: ABS 5678.0 Venture Capital and Later Stage Private Equity, Australia, 2007-8

In the USA comparable data is difficult to find. However, the National Venture Capital Association (NVCA) represents 460 venture capital and private equity firms (see www.nvca.org). In 2004, VC firms invested US\$21.2 billion. Of this 65% went into early or expansion stage companies and 33% went into later stage companies. One directory lists more than 1,400 VC firms in the USA (see www.vfinance.com).

In the UK, there are several VC directories, one of which is published by the British Venture Capital Association (BVCA). The BVCA has more than 170 full members and 150 associate members (see www.bvca.com.uk). Worldwide investment by UK PE firms was £9.7 billion. The number of companies financed was 1,301. Another VC directory for the UK is available from VCR Directory Online which lists more than 3,000 investors across Europe (see www.vcrdirectory.net).

General Partners have the responsibility of sourcing, evaluating and negotiating investments in private firms. This can be a lengthy and time-consuming task. Due to the immature nature of many of the firms being examined and the uncertainties associated with their products and business models, combined in many cases with the lack of proper systems or audited

accounting records, considerable expertise is needed to undertake the task effectively. Since such experience is in limited supply, Venture Capital Funds have difficulty recruiting senior managers, although the work may be outsourced in some areas to external advisors. The ability of the VC Funds to invest is constrained by the number and experience of their managers. At the same time, firms receiving investments (investees) are looking to their General Partners for advice, contacts and help securing customers, grants and staff.

When investee firms get into trouble, such as not achieving targets, making losses or losing key staff, General Partners need to devote considerable time to their current investments and have little time to source and evaluate new investments. General Partners will also be actively involved in setting strategy, planning and executing the exit. Around 70% of the General Partner's time is taken up working with their investee firms; hence the capacity of the Venture Capital Fund is limited. Venture Capital Funds therefore typically make few investments: only a few in any year. They often have limited time to carefully evaluate new investments and often spend only a few minutes on an executive summary establishing whether the proposal is worth further investigation.

Even when a proposition looks attractive, extensive time will be spent with the new venture team evaluating them as well as the merits of the business. Considerable due diligence will be undertaken before any investment is made. Often 20-30 or more proposals will be investigated for every single offer made.

The 2004 Australian Bureau of Statistics (ABS) survey reported similar ratios.

'The selection of investee companies (into which venture capital is invested) was an intensive process. The total of 137 venture capital managers reviewed 10,530 potential new investments during 2003/04 and conducted further analysis on 1,067 of those, with 181 being sponsored for venture capital. These managers spent a total of 179,000 hours with the investee companies (190,000 in 2002/03), advising and assisting in the development of the enterprises.'

Source: ABS 5678.0 Venture Capital, Australia Accessed 26/11/2004

In the 2007/8 ABS survey, fund managers spent on average 3.9 days a month on each investee company.

Due to the complexity of the business proposals, VC firms will often limit themselves to specific industry sectors where they have both the expertise to evaluate the deal as well as the experience and networks to add value to the investment. In the US and UK markets some funds have a single industry focus; however, in Australia most funds have a more general focus.

VC firms will also often limit themselves to certain development stages, such as start-up, expansion or buy out, where they can add real value. VC firms which spread themselves across too many sectors or too many stages will often be viewed less favorably by investors as they will see higher risks in such a spread. At the same time, larger funds prefer only to invest larger amounts as they can only support a limited number of investments. A typical fund invests in approximately 10-12 investee companies with individual investments of between 5-15% of the individual fund's total investment capital. The increasing cost of proposal analysis and subsequent due diligence is itself an inhibiting factor. If only one in ten proposals investigated are being invested in, the average cost of investigation of an investee firm is quite high. Therefore small investments are simply not economical.

The drift towards larger funds and the lack of early stage expertise within the VC community has led to an increasing shift of investments towards later stage investments. For example in 2003, 55% of venture capital investments in Australia went into various types of buy outs of existing businesses – the vital seed, start-up and early expansion phases accounted for only 16% of investments.

*Source: <http://www.smh.com.au/articles/2004/04/11/1081621834935.html?oneclick=true>
Accessed 31/12/04*

In the ABS 2007/8 survey the percentage in later stage private equity fell to 36% of total funds invested.

The 2005 ABS *Venture Capital* report shows the following breakdown of investments by stage:

Stage of development	Number	Value \$ million
Seed	145	65
Early	313	665
Expansion	265	1,183
Turnaround	34	118
Late	65	267
LBO/MBO/MBI	90	1,234
Total	912	3,532

For the 2004/5 year, 49% of investments went into ventures which were 2-4 years old and 26% into those which were 5-10 years old.

USA data from the MoneyTree™ Survey for 2004 shows the following breakdown:

Stage of development	Number	Value \$ billion
Startup/Seed	178	0.391
Early Stage	850	3.883
Expansion	1,217	9.653
Later Stage	700	7.578
Undisclosed/Other	–	–
Grand Total	2,945	21.506

Source: PricewaterhouseCoopers/Thomson Venture Economics/National Venture Capital Association, MoneyTree™ Survey, Total U.S. Investments by Year Q1 1995 – Q3 2005 <http://www.nvca.org>

2004 data for the UK from the BVCA showed the following:

Stage of development	Number	Value GBP million
Seed/Early Stage	264	188
Expansion	522	789
MBO	237	3,778
MBI	30	320
Grand Total	1,053	5,075

Of the total funds raised by UK VC firms in 2004 (£3.3 billion), 90% was expected to be invested in the MBO/MBI stages, 6% in expansion and 2% in early stage.

Source: <http://www.bvca.co.uk>

Many of the more successful and longer established VC firms receive so many business proposals that they restrict their time to recommended proposals from individuals or professional firms which have already reviewed the business plans, so they can better use their time. It also means that to access the better VC firms, an entrepreneur needs to first work with an Angel or professional firm which has access to the General Partners.

The legal structure of the fund, the manner of remuneration for General Partners and the process in which Limited Partners achieve a return of their initial investment plus their desired ROI, means that investments need to be harvested within a relatively short period of time. Most VC firms target a period of between 3-5 years for harvesting. However, if you take out the last year for the exit execution, this leaves only 2-4 years to create the pre-conditions for a successful exit.

If investments go over the five-year mark they are at risk of running up against the fund term. This means the General Partner has to apply to the Limited Partners for an extension or they need to force an exit event. To achieve a 25% compound return, they need the value of the investment to double almost

every three years. An investment that has been in play for six years needs the capitalised value to have reached 3.8 times the initial investment. If the VC fund only held 20% equity in the investment, a \$2 million investment in a \$10 million capitalised firm has to achieve an exit valuation of nearly \$38 million to provide the VC firm with a 25% ROI over the six years. Since few firms consistently achieve this type of growth, the pressure is on the VC firm to choose the right investments and then to actively manage them to get the desired growth rate.

Any slippage from the agreed targets will create considerable pressure on the VC to intervene to sell the business or to replace the management team to get the firm back on track. Few entrepreneurs seeking VC investment really appreciate the impact on the firm of a 25% cumulative growth in value and how difficult it is to reach.

Usually the VC fund is a minority investor which normally would give them little power or authority to force a sale of the investee firm. However, the investment agreement would typically provide the VC fund with the power to intervene to ensure they are able to exit under certain circumstances. Typical provisions would include the following:

Voting trust: Entrepreneurs hand over shares if they don't perform. The VC has the ability to take control, notwithstanding it is initially in a minority position.

Unlocking provision: A shareholder receives an offer they don't wish to accept but the VC does – the shareholder must buy the VC out.

Put provision: The VC may have the right to sell the business to the 'highest bidder' if an exit is not achieved by a given date.

Registration and public offering provision: The VC may require an IPO after a given date. If this is not possible, the firm will be sold.

Piggyback option: The VC can sell their shares anytime the business sells shares either in a public offering or in a trade sale.

Come along: The VC can force the business to sell shares if the VC receives an acceptable offer for its shares.

Drag along: The VC can force all shareholders to sell their shares if the VC receives an acceptable offer for its shares.

Tag along: If a shareholder receives a favourable offer for its shares, other shareholders have an option to notify the purchaser that they too wish to sell their shares.

For additional details see: D Gladstone and L Gladstone, 2002, Venture capital handbook – An entrepreneurs guide to raising venture capital, Prentice Hall, pp 180-208 and B Ferris, Nothing ventured, nothing gained: thrills and spills in venture capital, Allen & Unwin

Many people incorrectly think that VC General Partners are business experts who are knowledgeable about growing a business. In truth, most of them have a banking and finance background, with limited management experience outside the banking and finance sector and little hands-on experience in most of the markets in which they have investments. In many cases, the investment manager acting for the VC firm will be in their late 30s or 40s, have not worked in any sector other than financial services and have never undertaken any entrepreneurial activity. Their ability to help with specific experience in the development of a long-term strategy or with market development is limited. Some of the better funds have expanded their investment team with managers with operational experience, but these are certainly in the minority.

The more experienced General Partners will have learnt through a series of investments, will have developed good networks across a range of industries and will have participated in several exits as well as several write-offs. However, this experience can make them more cautious in their assessment of opportunities.

For the most part, VC General Partners are financial administrators. They are good at financial analysis, working the ratios, accounting for the money and making sure the legal requirements are satisfied. But they can only remain in the VC business if they can raise a new fund, since funds have a limited life. Raising a new fund means delivering healthy returns to their Limited Partner investors. That means getting both the investment and the exits at the right price. Without the exit returns, they don't achieve their bonuses and they don't have the opportunity to raise a new fund.

Mature VC firms which have been actively involved in funding emerging companies for a number of years have discovered just how hard it is to cope

with innovations, emerging markets and untried teams. Those VC firms typically have recruited senior staff who have technical (and often business) qualifications as well as a number of years of senior operational experience if not direct entrepreneurial success. In mature markets such as the USA, top VC firms will not employ an investment manager who does not have senior operational experience. While they have discovered that financial administration can be outsourced, operational experience is a real asset when it comes to understanding how a value proposition will achieve traction in the marketplace and understanding whether or not the management team has the attributes to build a good business.

Occasionally a VC firm will be able to sell to another VC firm which might be interested in taking the business to the next level of development. An early stage VC firm may sell their position to another VC firm interested in an expansion investment. This may also involve a further round of investment in the investee firm. VC firms attempt to maximise the value of their return through the most favorable exit vehicle. IPOs generally achieve the best returns with buybacks usually the lowest positive return. As an indication of the frequency of each type of exit, consider the following data sets.

In Australia, from March 2000 to September 2002 there were a total of 209 exits, of which 117 or 55.6% were at a profit, 10 broke even, and 79 or 37.8% were at a loss.

Source: <http://www.asto.com.au/news03/techbottoms.htm> Accessed 27/12/04

In 1999/2000, 24 companies were sold, 12 companies went public, four companies were bought back and 19 investments were liquidated. The value of exits during the year 1999/2000 was A\$536 million. The average trade sale was A\$3.7 million, while the value of all IPOs was A\$346 million.

*Source: Venture Capital in Australia (Research Note 28 2000-01)
<http://www.aph.gov.au/library/pubs/rn/2000-01/01RN28.htm> Accessed 31/12/04*

Not all exits can be achieved quickly, as this data from 1995-2001 shows.

Exit path	Full exit	Partial exit	%
IPO	22	16	29.3
Private (undisclosed)	10	1	8.4
Acquisition	25 (cash)	5 (shares)	23.0
Secondary Sale	9	1	7.7
Buyback	9	8	13.1
Write-off	24	0	18.5
Total	99	31	100

Source: G Cumming and G Fleming, 2002, 'A law and finance analysis of venture capital exits in emerging markets' Working paper series in finance 02-03, Australian National University

The ABS 2005 and 2007/8 Venture Capital Reports show the following exit statistics:

Exit path	Value A\$ million	2005	2007/8
Trade Sale		291	456
IPO		246	376
Buyback		35	11
Write-offs		49	45
Left the Industry		215	162
Total		836	1,050

Ratios for the USA are comparable. Data from Q3 2005 from the NVCA showed that there were 19 IPO exits compared to 76 trade sales (25%).

Source: <http://www.nvca.org/pdf/2005Q3IPOreleasefinal.pdf> Accessed 5/12/05

Data from the NVCA in the USA for 2004 show investment losses occurred in 61 of the 181 exits (34%); however, 20 of the 181 (11%) exits resulted in the VC firm achieving more than 10 times their investment.

*Source: http://www.ventureeconomics.com/vec/news_ve/2005VEpress/VEpress05_04_05.pdf
Accessed 11/12/05*

Exit data from the UK for 2004 shows that, by value, 28% was from trade sales, 20% were sales to another private equity firm, 13% were write-offs and 10% was from IPOs.

Unlike VC funds, Angels are not restricted by the closed fund limitation, thus they can stay with their investments longer if the occasion warrants. They can also be more selective with their investments. The General Partner of a VC fund is under pressure to allocate the money during the early phase of the fund and so a high volume of possible deals needs to be sourced for evaluation. Angels can invest without an expectation of a positive return, perhaps to 'give back' or to fund or assist a young entrepreneur. The VC firm can really only be involved if it can see a healthy return for their Limited Partners.

Angels typically invest in one in three proposals which they evaluate where VC funds only invest in one in one hundred. Perhaps, because of the higher cost of investing and the higher return expected, the VC firm has a much more difficult task in finding appropriate investments.

Private Equity Funds

Another form of private equity is the Private Equity (PE) Fund, a term normally reserved for funds which invest in late stage ventures. Where Venture Capital Funds typically take a minority investment in a firm and actively manage through the original management team, the Private Equity Fund typically takes 100% or a majority stake in an investment. PE firms typically aim to acquire firms where direct intervention can overcome prior problems or constraints and provide a short-term turnaround situation or performance uplift which will yield an attractive return. PE firms look for inefficiencies to exploit. Common approaches are:

- Improve the profitability. Access to more experienced management, networks and technical knowledge may provide the basis for a relatively easy improvement in profitability.
- Buy at a favorable price when the market is low and wait until the market improves when valuation multiples are higher.
- Break the business up and sell off the assets or business units. Some businesses are undervalued where one part of the business is more risky or where the market does not understand the business economics. More focused businesses will often sell at a higher multiple.
- Leveraged buy out. The PE firm uses debt to finance a major part of the buy out. When the value improves, the returns to the equity portion are magnified due to the high debt component.
- Management buy-out.
- Management buy-in.
- Make bolt-on acquisitions to generate economies of scale or gain access to new products or markets.

PE could be used to remove the burden of existing debt which might allow the business to reinvest and grow. Existing management may be retained with incentives or may be allowed a minor equity position as an incentive.

PE investment may be used to provide existing management with the opportunity to buy out the existing owners, re-engineer the business and then position it for an IPO. The PE firm would use the IPO as their exit strategy leaving the management team in control post IPO.

PE funds have become active in 'sell down' transactions in recent years. This occurs where the PE fund buys shares from a founder representing only part of the ownership, although most often the majority. In this way, the founder has the opportunity to cash out part of their investment in the enterprise. The PE firm will then work with the founder to actively progress the business to a higher exit valuation which could be achieved either through an IPO or a trade sale. In undertaking the development strategy, the PE firm may arrange for additional debt financing, replace some of the management team, restructure the Board of Directors, assist with acquisitions and development of new strategic partnerships and so on.

This strategy has the advantage of allowing time for the business to be properly prepared for an exit with the active co-operation of the founder and the management team. The founder may also achieve a secondary harvest at a higher valuation. An Angel might seek out a PE fund as an exit strategy if the business could be substantially developed with significant capital injection, a new management team or as part of a roll-up strategy.

Corporate Venture Capital

An Investor may co-invest with a corporation or seek follow-on funding from a corporation as part of an exit strategy. Many corporations have Venture Capital Funds specially for the purpose of investing in early stage ventures. The manner in which these corporate funds are managed and the terms under which funds are invested closely mirror traditional Venture Capital Funds. Ventures successful in acquiring a corporate investor can often gain additional benefits beyond those which can be offered by the traditional Venture Capital Fund.

Corporations have a variety of reasons for investing in early stage ventures although the most common are:

- access to specialised knowledge, intellectual property or equipment
- exposure to emerging technologies
- investment in potential acquisitions
- understanding of new or emerging markets
- access to entrepreneurial talent
- preventing competitors from acquiring a technological breakthrough.

For the new venture, a corporate investor could provide the following benefits:

- access to industry expertise, networks, equipment and/or research and development facilities
- access to a key customer or to an established distribution channel
- access to complimentary technologies.

Typically, Corporate Venture Funds invest in their core or closely related technologies.

According to a joint study by Venture Economics and the National Venture Capital Association in United States, in 1994 only 2% of venture capital investments were corporate venture capital, but in 2000, corporate venture capital accounted for 17%, nearly US\$20 billion. In four years, from 1996 through the end of 1999, the number of companies investing in outside ideas increased elevenfold, from 30 to 330. During the same period, corporate venture capital spending rose from US\$100 million to US\$17 billion annually.

*Source: http://www.1000ventures.com/business_guide/corporate_vinvesting_external.html
Accessed 3/01/04*

In 2003, US\$1.1 billion was invested in the USA in growth orientated companies by corporate venturing groups, representing 6% of all VC investment. The amount invested by corporate venture capitalists has tracked similarly to the trends of the overall VC industry. The 2003 figures were close to the activity seen in the last pre-bubble year, 1997, when corporate venturing groups invested US\$957 million, also representing 6% of total VC invested in that year.

Source: http://www.nvca.org/nvca02_04_04.html Accessed 3/01/04

There is limited information available about Corporate Venture Capital Funds in Australasia.

Overseas and local corporations may undertake venture investments through a local fund, via a traditional Venture Capital Fund or through a local subsidiary. The major problem which most corporate businesses have with VC investments is access to experienced VC executives. Since the VC investment model is one of active intervention as well as portfolio investing, this type of investing is foreign to most corporations. Many will invest in an established VC fund in order to access the investment evaluation experience and venture investment skills.

An early stage venture which can clearly show how their innovations relate to the business of a large corporation should include that corporation in their list of potential investors. However, corporations not familiar with investing in early stage ventures can be a mixed blessing. Because they are not familiar with

the norms of such investments, the firm may find itself wasting considerable time trying to convince the corporation of the value of an external investment, although benefits may come from a more favorable valuation, access to corporate resources and an early exit opportunity.

The entrepreneur should be wary of the motivation of the corporate investor. Their involvement is mostly driven by their own strategic objectives and their support may be highly influenced by wanting the investee firm to develop in a particular direction. They may inhibit, consciously or unconsciously, the direction of the business and limit the exit opportunities.

Angel Investor Finance

Angel investors, often simply referred to as Business Angels or ‘Angels’, are high net-worth, non-institutional, private equity investors who have the desire and sufficiently high net worth to enable them to invest part of their assets in high-risk, high-return entrepreneurial ventures in return for a share of voting, income and, ultimately, capital gain.

Angel investment is normally the first round of external independent investment. Angels normally invest in early stage ventures where the founding team has exhausted their personal savings and sources of funding from family and friends. These ventures are not sufficiently developed to stand on their own, or sufficiently attractive to gain venture capital funding. These ventures exist in a halfway state, often between possible failure and take-off. Typically the management team lacks experience in a growth venture and the business needs not only the additional funding, but also mentoring to take it to the next stage of development.

Investing in early stage private companies has many drawbacks, which is why this form of investment is typically undertaken by individuals who can afford to lose the money and/or are willing to wait some years before they see a return on their money.

To put this into context, private early stage ventures have the following attributes:

- The shares are not freely traded and no established market exists for them. An investor is forced to wait for a liquidity event such as a trade sale or a public listing.
- Novel business concepts and inventions are often associated with emerging and untried markets. The risks in the venture are likely to be higher and some aspects of the business subject to high levels of uncertainty.
- Products may be new and/or under development and still subject to technical and market risks.
- The knowledge of the product and its design may be highly dependent on a small number of key staff, who may not necessarily have proven business experience.
- The small size of new ventures and their lack of presence in the market mean they may be highly susceptible to changes in market conditions. Timing may be critical to survival. Small delays in product release or in achieving revenue milestones may be sufficient to cause failure of the enterprise.
- There is limited access to further finance if the business encounters delays or undertakes operations which require additional funds.
- Early stage ventures typically have little collateral to pledge for loans.
- Early stage ventures often have a high cash burn rate as they have yet to reach a critical mass where they are self-funding.
- Funding for acquisitions or expansion can be limited.
- Valuations are problematic – if not speculative. Shares are not readily traded and so no public market value exists for the firm. Often there is little historical performance and future revenues and profits are uncertain.
- Minority shareholders have little power unless it is through an investment agreement. Even if they disagree with management actions, they have little power and can't sell their shares easily.

Angel investments are both risky and problematic. Since most new venture entrepreneurs lack the business experience to anticipate many of the problems they will encounter as the enterprise grows, the investment risk is generally seen as considerably higher than a public corporation.

Private equity investment is often referred to as ‘investing in securities through a negotiated process’. Unlike purchasing shares in a public company, the investor in a private enterprise negotiates the terms and conditions under which the investment will be made. A defining characteristic of Angel investing is that it is a ‘transformational, value-added, active investment strategy’, in which the investor expects to have a hands-on approach to their investments, not possible in public company investments.

Entrepreneurs often seek out Angel investors to help them develop their business. Apart from the funding they bring, an Angel would be expected to contribute in one or more of the following ways:

- industry experience
- experience in start-up or business building
- networks
- experience in raising venture capital
- access to VC firms
- access to strategic partners.

There are different types of Angels. An Angel with direct experience in the firm’s industry and with entrepreneurial experience can help with business development, recruitment, sales, strategy, contacts and so on. Their expertise and experience can be an invaluable help in developing the business. Often cashed-up entrepreneurs with start-up experience will invest back into new ventures. They can bring the experience of a successful venture through its growth stages. However, they may not have experience in the industry in which the firm operates. Wealthy and/or retired corporate executives often make investments in new ventures within their industry. They can assist with customer introductions, recruitment and risk assessment. However, many Angels are simply wealthy individuals with a desire to invest in the private sector and their only real contribution is finance.

The new venture entrepreneur may find Angel investment very useful as a bridge to VC finance. The Angel can provide much needed finance as well as assist in developing the business further to prove the business model.

One Canadian study showed that 57% of firms with Angel financing subsequently obtained VC funding.

Source: <http://www.smartlink.net.au/library/riding/1> Accessed 31/12/04

However, Scott A. Shane in his book 'Fools Gold?: the truth behind angel investing in America' disputes this as a general relationship and indicates that the probability of follow on VC is significantly lower.

So what does the typical Angel look like? There have been a number of studies of Angels across several countries; however, because Angels typically stay out of the public eye and are often reticent to speak of their investing experience, data has been difficult to collect and therefore the samples have been relatively small. Even so, the findings are relatively consistent across several studies.

The Center for Venture Research at the University of New Hampshire has created a profile of the 'typical (USA) Angel investor'. The predominant characteristics are:

- Angels tend to invest close to their home base, usually no further than a half-day's drive.
- Individual Angels rarely invest more than a few hundred thousand dollars in total.
- Angel investors tend to be older, wealthier and better educated than the average citizen, yet a large number are not millionaires.
- Angels anticipate an average annual return of 26% on their investments.
- Angels expect that up to one third of their investments will fail, resulting in significant capital losses.
- Angel investors reject seven out of every 10 deals that cross their desks.
- Deals are rejected for a variety of reasons, including poor growth potential, overpriced equity and inexperienced management team.

Source: http://wsbe.unh.edu/cvr/cap_locator.cfm Accessed 21/01/06

An overview of the Australian Angel investment environment is provided below:

Example

'The private nature of Angel funding means that much information about activity in Australia is anecdotal.

It appears that most investors are worth upwards of A\$10 million, often have an entrepreneurial background and take stakes of between A\$250,000 and A\$4 million. Equity investment generally concerns small or medium sized enterprises (SMEs).

Some Angels also provide loan finance, independently or as part of packages from lending institutions.

Some government and industry studies suggest that the size of the local Angel market is 35% to 50% of VC investing, significantly lower than that of Canada, the US and UK where Angel investing is greater than the total of formal venture capital funding.

Investment criteria appear to be similar to those of VC funds (e.g. rate of return, cash flow, capital growth and time to exit). Most Angels, in contrast to VC fund managers, appear to be averse to publicity – one reason may be wariness about approaches by entrepreneurs – and limited requirements for public disclosure of investments means that information about the sector is problematic. They appear to be biased towards early stage and start-up enterprises rather than funding expansion capital or management buyouts.'

Source: <http://www.caslon.com.au/ecapitalguide3.htm> Accessed 25/10/03

In their book *Angel Capital*, Benjamin and Margulis describe the typical USA Angel as follows:

- 46-65 years of age, male
- postgraduate degree, often technical

- previous management experience, started up, operates or has sold a successful business
- invests between US\$25,000 and US\$1 million per transaction
- prefers participation with other financially sophisticated individuals
- strong preference for transactions which match with technical expertise
- 23% prefer to invest close to home
- maintains an active professional relationship with portfolio investments
- invests in one or two transactions per year
- diversification and tax shelter income are not the most important objectives
- term for holding investment is eight years
- looks for rates of return from 22% to 50%: minimum portfolio return 20%
- learns of investment opportunities primarily from friends and trusted associates; however, majority would like to look at more investment opportunities than present informal referral system permits
- income is US\$100,000 per year minimum
- self-made millionaire.

By contrast, a study by Professor Kevin Hindle and Robert Wenban of Australian Angels found that: there were two dominant groups – those with university education and those without, they were slightly younger than their American equivalents, invested less per transaction and were mostly ‘general managers’ or ‘people managers’ by background, although most had been involved in several start-up ventures. They typically invested 10-14% of their net worth in new ventures, although one quarter invested over 25% of their net worth. They were investing in about one third of proposals considered.

Source: Kevin Hindle and Robert Wenban, 1999, Australia's informal venture capitalist: an exploratory profile, Venture Capital, p199, Vol. 1. No. 2

Motivation for investing varies slightly among the countries for which survey data is available. Benjamin and Margulis, in their book *Angel Capital*, provide the following reasons:

- improve self-image, self-esteem and recognition, 'you never know how much you know until a small company turns to you'
- alleviate concerns – help others
- obligation to give back, the 'joy of giving'
- get 'first crack' at next high-rise stock prior to IPO
- habit, addicted to high-risk 'rush'
- fun and exciting
- ROI 30% minimum
- desire to take charge of the stock selection process more directly.

It may be that their sample has more hi-tech Silicon Valley entrepreneurs and thus is not representative of Angels in other countries.

Data from Scotland shows similar reasons for becoming a Business Angel.

Reason	Main reason number	Main reason %	Other reasons number	Other reasons %
To give something back	11	7.9	49	35
For capital growth	64	45.7	46	32.9
For income	12	8.6	28	20
To create a full-time job for myself	8	5.7	13	9.3
For tax advantages	2	1.4	36	25.7
To give myself a part-time interest	18	12.9	55	39.3
Enjoyment and satisfaction	13	9.3	77	55.0
Other	4	2.9	4	2.9
Unidentified	8	5.75	–	–
Total	140	100	–	–

Source: Stuart Paul, Geoff Whittam and Jim B Johnston, 2003, The operation of informal venture capital market in Scotland, Venture Capital, October, Vol. 5. No. 4

In contrast, Australian Angels appear to have a greater focus on the investment returns.

The amount of net worth invested in private equity by Angels varies considerably and appears to be somewhat based on the total worth of the individual as well as their prior background. Estimates vary from 5-50% of net worth with the average differing across countries. For example, one German study reported the average to be 20%.

Amounts invested by Angels tend to vary from country to country. Individual investments tend to be somewhat larger than where Angels act in a group to co-invest. The majority of Angel investments are co-investment situations.

Co-investments by Business Angels:

Co-investor	Investments in technology-based firms		Investments in non-technology based firms	
	No.	%	No.	%
None	5	10.6	24	29.6
Other Business Angels in the same syndicate	9	19.1	20	24.7
Other Business Angels who invested independently	11	23.4	16	19.8
Venture capital funds	6	12.8	7	8.6
Banks	1	2.1	8	9.9
Public sector	0	–	3	3.7
Multiple (Two or more of the above)	15	31.9	3	3.7
Total	47	100	81	100

Source: Colin Mason and Richard T Harrison, 2004, Does investing in technology-based firms involve higher risk? An exploratory study of the performance of technology and non-technology investments by business angels, Venture Capital, October 2004, Vol. 6. No. 4

In a Scottish study, 38% of Angels had an SME background while 60% had no SME experience. Similar studies have been undertaken in Australia, Germany and Singapore. While the distribution of responses is not identical for each country, the results are not markedly different.

Rates of investment compared to deals screened seem to be comparable across several western countries. A German study reported an investment rate of one or two out of every nine investigated. Investments take generally between 20 to 90 days from initial contact and involve, generally three to six negotiation sessions.

Research in the USA suggests that Angels invest in about 10 times the number of companies as the VC firms but the total amount of investment by dollar value is somewhat similar. The most recent estimate (2002) is 400,000 active Angels in the USA investing US\$30-40 billion in 50,000 early stage ventures.

‘Through 2001, the 220 members of Tech Coast Angels (Los Angeles, Orange and San Diego Counties) made approximately 800 investments in 52 companies totalling US\$40 million in 81 rounds of investments. The average investment is just over US\$40,000 and 95% of the individual investments have been in the range of US\$20,000 to US\$100,000. Fifty per cent of the investment rounds totalled US\$500,000 or less.’

Source: William H Payne and Matthew J Macarty, 2002, The anatomy of an angel investing network: Tech Coast Angels, Venture Capital, Vol. 4, No. 4

Returns on investment and exit paths tend to vary from country to country, possibly depending on the state of the economy at the time of the research, the availability of a robust secondary public listing market and the type and availability of potential deals.

A USA study published in 2002 showed that a quarter of the Angel investments were achieving better than a 50% rate of return and generally exiting the investment through a trade sale.

Source: Jeffrey Sohl, 2003, The private equity market in the USA: lessons from volatility, Venture Capital, Vol. 5 Issue 1, p 29.

Investment returns IRR	Investments in technology-based firms		Investments in non-technology based firms	
	No.	%	No.	%
Loss	17	36.2	34	42.0
Break-even (0-9)	11	23.4	17	21.0
20-49	6	12.8	13	16.0
50-99	7	14.9	10	12.3
100 and over	6	12.8	7	8.6
Total	47	100	81	100

Source: Colin Mason and Richard T Harrison, 2004, Does investing in technology-based firms involve higher risk? An exploratory study of the performance of technology and non-technology investments by business angels, Venture Capital, October 2004, Vol. 6. No. 4

Angel investor exits by the Tech Coast Angels, 1997-2001

Activity	Number
Investments	52
Operating independently	32
Exits	20
• Out of business (-1X)	• 10
• Partial return of capital (0 to - 9X)	• 5
• Sale to private companies (exit pending)	• 3
• IPO (2X - 3X)	• 1
• Sale to public company (+120X)	• 1

Source: William H Payne and Matthew J Macarty, 2002, The anatomy of an angel investing network: Tech Coast Angels, Venture Capital, Vol. 4. No. 4

‘This paper provides the first attempt to analyse the returns to informal venture capital investment using data on 128 exited investments from a survey of 127 Business Angel investors in the UK. The paper finds that the distribution

of returns is highly skewed, with 34% of exits at a total loss, 13% at a partial loss or break-even, but with 23% showing an IRR of 50% or above. Trade sales are the main way in which Business Angels harvest their investments. The median time to exit for successful investments was four years. Large investments, large deal sizes involving multiple co-investors, and management buyouts (MBOs) were most likely to be high-performing investments.'

Source: Colin M Mason and Richard T Harrison, 2002, Is it worth it? The rates of return from informal venture capital investments, Journal of Business Venturing, Vol. 17. No. 3.

Exit routes for technology and non-technology investments

Exit route	Investments in technology-based firms		Investments in non-technology	
	No.	%	No.	%
Flotation	6	14.3	3	3.9
Trade Sale	12	28.6	19	24.7
Sale of shares to existing shareholders	3	7.1	16	20.8
Sale of shares to third party	6	14.3	6	7.8
Written off/shares have no value	15	35.7	32	41.6
Asset break-up	0	–	1	1.3
Total	42	100	77	100

Source: Colin Mason and Richard T Harrison, 2004, Does investing in technology-based firms involve higher risk? An exploratory study of the performance of technology and non-technology investments by business angels, Venture Capital, October 2004, Vol. 6. No. 4

'On the average, 60 - 65% of these investments break even or represent a partial or total loss. So a substantial portion, 6 out of 10, even after meticulous due diligence, result in no financial return or in returns below that of a bank deposit account. Approximately 20% of these investments, based on our research, provide a two to five times multiple on the investment. About 8-9% provide between 5 and

10 times the investment, and about 7 times out of 100, about 6.9%, we see a return of 10 times or more the investment made.'

Source: <http://www.icrnet.com/faq/home.html#q17> Accessed 22/01/06

Angel Capital Education Foundation reported that, for the 539 Angels surveyed across 86 Angel Groups they reviewed in 2007, the average return on the 1,130 exits of that year was 27%. (www.angelcapitaleducation.org)

When they do invest, Angels will stipulate similar conditions to their investments as VCs. Typically they will require:

- a position on the Board of Directors
- remuneration for their time spent on the business
- veto power over the issue of new shares
- adjustment of the number of shares issued to the investor if milestones are missed and/or a lower valuation is set in a subsequent round of investment
- veto power over further long-term debt
- approval rights over executive remuneration
- approval rights over issue of options
- the right to put the business up for sale if certain milestones are not achieved
- the right to replace the CEO if certain milestones are not achieved.

Angels are normally active 'hands-on' investors. They expect and often enjoy being directly involved in the management of the venture. In fact, this is often one of their prime reasons for investing. They typically spend time with each of their investments on a regular basis.

A study of Angel investors in Germany showed that Angels typically spent 6.2 days per month on their investments, averaging 1.34 days per month on each investment, with the most time being spent on their most recent investees. More active investments might involve a day per week.

Source: Malte Brettel, 2003, Business Angels in Germany: a research note, Venture Capital, July 2003, Vol. 5. No. 3

Angel investors play a very important role in developing early stage ventures. It is their combination of funding and mentoring that makes their contribution so advantageous to a fledgling business. Certainly, without Angel help, many early stage businesses would flounder. Even though many fail, at least half grow into more substantial businesses providing essential job and wealth creation.

There are many sites offering information on Angel finance in the USA and several directories of Angels and Angel Networks. One site offers access to more than 20,000 Angels (see www.vfinance.com). The Angel Capital Association has an extensive list of Angel Networks.

For some background to Angel investing in the United States of America see *Note on Angel Investing* – Prepared by Michael Horvath and Fred Wainwright, Center for Private Equity and Entrepreneurship, Tuck School of Business at Dartmouth University 01/05.

Source: <http://www.empea.net/peindustry/research.aspx> Accessed 11/12/05

The UK National Business Angels Network (NBAN) estimates that there are currently 18,000 Business Angels in the UK investing roughly £500 million into 3,500 businesses every year. Information on Angels and Angel Networks within the UK can be found through the British Business Angels Association (BBAA) which is the National Trade Association for the UK's Business Angel Network.

Source: <http://www.bbaa.org.uk/portal/content/view/12/50/> Accessed 11/12/05

In Australia, Angel Networks are listed on the website of the Australian Venture Capital Association (see www.avcal.com.au). Australia has an association of Angel groups called the Australian Association of Angel Investors (www.aaai.com.au) where you can find details of Angel Groups.

A recent report on Australian Angels entitled "Study of Business Angel Market in Australia" by Professor Michael Vitale, Belinda Everingham and Richard Butler (November 2006) is available at:

http://www.usicom.com/filelib/PDF/ResearchLibrary/Business_Angel_Report.pdf

Strategic v.s Financial Ventures

There are basically two types of ventures which attract Angel or VC investment. These ventures create a return to the investor through their exit event. Financial ventures create value on exit via a financial trade sale or an IPO by assigning a value to the future profit generating power of the entity being sold. Alternatively, a strategic venture creates exit value, not on the basis of what profit it could inherently generate, but on the basis of what future profit could be generated by the buyer exploiting the underlying assets or capabilities of the entity being acquired. These are fundamentally different types of businesses and the Angel or VC investor has to ensure that the business development process and the exit preparation align with the appropriate exit.

In order to assess the potential exit value of any entity, we must first understand how the business creates value for its buyer (financial or strategic sale) or its future public shareholders (IPO). Those businesses which deliver inherent profitability must create value for its future owners through enhanced profitability and future profit growth. By contrast, strategic value businesses create value by enabling a large corporation, the strategic buyer, to exploit a significant revenue opportunity enabled through the combination of the two companies. The strategic seller builds value by developing strategic assets and capabilities which a large company will exploit.

In the case of a strategic sale, it may not matter whether the selling business is making a profit, has revenue or is growing. This is in direct contrast to a financial exit which is entirely based on revenue and profit growth which the business itself must deliver to its new owners.

Because these outcomes are very different, the manner in which the Angel and VC investors will evaluate the investment and then should plan the exit for their investee business depends greatly on which type of exit is most appropriate.

I have grouped financial trade sale and IPO under the financial exit as they both have the same basic value creating process, they both need to generate a future stream of positive earnings to create a successful exit event. The IPO exit is an extreme situation of a financial venture where the projected revenue levels and the projected market capitalization is very high. While the IPO exit requires a more sophisticated organization to be successful, the fact is that both the financial sale and the IPO require a proven, high growth potential business concept to generate a successful exit value.

Smaller firms and firms with limited growth potential which create value through projected net earnings need to be directed towards a financial trade sale as they will not be able to meet the rather high threshold of revenue and potential growth requirements needed for a successful IPO. Given that only a very small percentage of firms are able to achieve IPO status, the vast majority of firms need to be prepared for a financial sale. For the purposes of this discussion, I am going to refer to all financial exits as a 'financial sale' with the understanding that some exceptional firms will be able to achieve an IPO. Also, for the purposes of this discussion, I am going to assume that all financial exits will be to an individual or corporation, that is a 'financial buyer', and that the buyer is setting the purchase price based on the anticipated future stream of earnings from the acquired firm alone. That is, the buyer is not assigning any synergy or benefit to the acquisition based on what is happening, or could happen, in the rest of the buyer's organization.

The financial sale is very different from a strategic sale where value is created through the combination of the buyer and seller businesses. We have all heard of businesses which were sold for many times revenue and

staggering multiples of profit. These situations are all cases where the business being acquired had something which the large corporation needed to counter a major threat or to chase after a major new revenue opportunity. Most of these acquired businesses had unique intellectual property, deep expertise or well established brands or rights (e.g. to exploit forests, minerals, fishing etc). The assets or capabilities being acquired were considered by the buyer to be too expensive to copy, build or develop, or would take the buyer too long to assemble or to create internally. The delay in acquiring the asset or capability may also expose the acquiring corporation to an unacceptable level of risk.

In a strategic acquisition, a small business can often provide the means by which a large corporation can quickly generate many times the purchase price by leveraging its own assets and capabilities alongside those being acquired. Such acquisitions are bought, not on the basis of the profits of the acquired business, but on the value which can be generated within the combined entity. Few acquisitions, however, fit this profile. I will use the terms 'strategic sale' and 'strategic buyer' to describe a situation where a business is sold on the basis of its strategic value to the acquirer.

Businesses which are typically sold to a strategic buyer are those in biotechnology, information technology, research and development, designer fashions, mineral exploration, agricultural science, computer hardware and telecommunications. Also companies in consumer packaged goods with strong brands or with manufactured products which have global market potential can often secure significant premiums on sale. Acquisitions which can deliver very significant synergies in operating costs through integration would also fit into this category.

Probably about 95% of all private businesses which are sold are acquired by a financial buyer. In some, there will be synergies in the acquisition but these will be minimal and not sufficient to override the need for the acquired business to show its inherent profitability. Most companies don't have the type of assets or capabilities to leverage large scale opportunities for an acquirer. Instead, they build profits through their own inherent competitive advantages for a local customer base.

A financial buyer seeking an acquisition will often have many choices of similar businesses, although sometimes geographically separate. The buyer may be buying a business to own and manage or a corporation undertaking a consolidation strategy by acquiring many businesses of a similar type. What the financial buyer is acquiring is a profit stream and so the basis of the purchase is simply how much profit the firm makes now and is likely to make in the future. Purchase value is calculated almost purely on the inherent profitability of the acquisition with little regard to the combination synergies in the acquisition. The seller to a financial buyer must put effort into increasing profit and profit potential.

Businesses which would normally be sold to a financial buyer are professional services firms, marketing firms, management consultancies, distribution companies, trucking companies, most retail businesses, wholesalers, import/export companies, agricultural enterprises, printers, professional practices, builders, construction companies and so on. Non complex manufacturing also attracts a high proportion of financial buyers. Basically any business which does the same as many other businesses will fall into this group.

Businesses acquired to be operated as a stand alone business will be purchased on the basis of their inherent profitability as there are no synergistic benefits in the deal for the acquirer. Therefore, a business bought by an individual who wants to invest retirement or redundancy funds to buy a business to manage will be a financial sale. Similarly, a business purchased by a private equity fund which intends to increase its profitability through new management, increasing its debt level and refocusing the business will also be a financial sale.

Businesses acquired by corporations can be expected to have both financial and strategic contributions. Many acquisitions are undertaken for roll-up, consolidation or expansion purposes. These businesses typically are purchased to add revenue and profit generation through their own inherent operations although the acquirer may gain some synergistic benefits from operating at a larger scale or some benefits through reducing duplicate functions, but the prime consideration is generating operating profit from the business purchased. The purchase price would be driven by the current and potential profit of the acquired business itself. While the additional synergies may make it more attractive, the seller would need to prepare the business for a financial buyer.

Acquired businesses which are expected to contribute significant synergistic benefits to the acquiring corporation may contribute little inherent profit. They are acquired because of the benefits which the acquiring corporation expects to achieve through the combination of the businesses. In most cases, these acquired businesses bring some asset or capability to the acquirer which the corporation is able to leverage through their own operations thereby generating significant future revenue and profits for the acquirer. A seller who was able to make such a contribution would seek out a strategic buyer.

Some firms will be able to do both. That is, they will have good profit capabilities and also be able to provide strategic benefits to the acquirer. But one will be more significant than the other. To the extent that strategic value benefits are greater than inherent profitability benefits, the seller would be much better off seeking a strategic buyer. Financial sales are always going to be limited by the profit generating capability of the seller. A strategic sale, however, is only limited by the size of the opportunity generated within the acquiring corporation. Thus, a very large corporation that can significantly leverage the strategic contribution of a small acquisition may be prepared to pay many times its financial sale value to ensure it receives the benefits of the acquisition rather than allow it to be acquired by one of its competitors.

I have extensively examined the process of a financial trade sale and have documented a methodology in my book, *The Ultimate Deal 1*, which can be used by business owners to significantly improve their sale value.

My book, *The Ultimate Deal 2*, examines strategies which owners of businesses with strategic value will use to sell their businesses to a strategic buyer. Angels and VC investors who wish to examine the strategic sale preparation process in greater detail should also read my e-book '*Invest to Exit*'.

Financial or Strategic Sale – Which One?

I often confront entrepreneurs with existing investments with a stark choice – what is the best strategy to prepare your business for a sale – build up the profits or develop underlying assets and capabilities for a strategic sale. You might well ask ‘Why can’t you do both?’.

Financial v.s Strategic Buyer Strategies

Attribute	Financial Buyer	Strategic Buyer
Source of value to the buyer	Profitability, risk minimization, growth potential.	Threat elimination and/or revenue potential in the combination of the two businesses.
Value created by	Increasing profits, reducing risk, future growth and proven growth potential, roll-up or consolidation opportunities.	Underlying assets and capabilities which the buyer will leverage to eliminate a threat or exploit a large revenue opportunity.
Additional value created by	Increasing current profits, increasing growth rate, developing additional substantiated growth potential.	Reducing integration time, increasing rate of scalability and speed of exploitation, adding additional strategic assets and capabilities for the buyer to exploit.
Buyer	Individual, investment trust, private equity firm, corporation undertaking a roll-up or consolidation strategy.	Large corporation which can exploit the strategic assets and/or capabilities in a large customer base.

Attribute	Financial Buyer	Strategic Buyer
Impact of increased profitability	Major impact on value.	May be irrelevant. Profits are only needed to ensure survival prior to a sale.
Size	Any size.	Large acquisitions may have difficulty creating sufficient new incremental revenue.
Existing growth	Significant impact on value.	Size must be sufficient to allow a critical mass platform for opportunity exploitation. Growth itself may not be important.
Growth potential	Significant impact on value.	May have no impact on the buyer's opportunity.
Underlying assets and capabilities	Must deliver competitive advantage within the seller's business as a stand alone entity.	Must deliver a sufficiently large and robust base for exploiting a strategic opportunity in the combination of businesses.
Inherent risks	Must be eliminated wherever possible.	Must be eliminated wherever possible.
Succession planning	New buyer must be able to run the business if the senior management leave.	Key manager and key employees needed to exploit the opportunity must be retained.

Attribute	Financial Buyer	Strategic Buyer
Advisors	Business broker, professional services firm, business advisor	Large professional services firm, investment banker.
Preparation time	18 months to 2 years	Normally 2 years or more.
Level of integration	Most often continues as a sole business or might be loosely integrated bolt on acquisition. May contribute administrative synergies in a consolidation.	Varies. Often fully absorbed. Sometimes integrated into only one part of the business. Could be left as a stand alone entity passing products, IP or processes to group.

I am sure that some companies can do both, but when they look at the processes involved and the priorities which will determine where to use their surplus cash, you often see a clear choice – they don't have the resources to do both so they need to decide which strategy is going to give the highest exit price.

There is sometimes the possibility that a single venture can throw off more than one exit. This can happen where the firm has developed IP across multiple markets or solves quite different problems. It may be worth separating the different IP into distinct ventures and preparing each for an exit.

Another possibility is that a single venture may have quite different activities each of which could be directed towards their own sale, perhaps with some being financial sales and others being strategic sales. This can happen, for example, where IP is the basis of a sales transaction of a product but is then followed by maintenance or service sales. The IP may appeal to a global corporation but they may have no interest in the local services business. In such a case, it may

be worthwhile splitting the business and selling the different parts to different buyers.

Companies which are sold as a financial sale are those which provide the buyer with a platform which enables the buyer to generate a stream of future earnings through the use of the resources contained within the acquired business. While these might be augmented by the buyer through the insertion of better processes, more capable management and better funding, essentially it is the same underlying business which is generating the profit stream. Thus any acquisition valuation will be based on the net present value of those future earnings. Most businesses fall into this category. Financial buyers typically buy retail, wholesale, light manufacturing, transport, property and services based businesses.

You increase the value of such businesses by reducing the inherent risks for the buyer, improving the visibility and reliability of future earnings forecasts, improving on-going profitability, building growth into the business and finding ways to create growth potential for the buyer.

By contrast, those businesses which appeal to strategic buyers have some underlying assets or capabilities which a large corporation can exploit through the buyer's own organization. Small companies will often develop products or services which can be sold by the acquirer through their very large distribution channels. In the right circumstances, a buyer might be able to scale the revenue by 50 to 100 times that of the seller just by having the right access to global customers. The key to a strategic sale is to find a large corporation which can exploit the underlying asset or capability of the seller to generate very large revenues. In these situations the size, revenue, number of customers or employees or level of profits of the seller may be entirely irrelevant. It is the size of the revenue opportunity of the buyer which is the key to strategic value.

A business which has the right type of assets or capabilities which can generate strategic value may be much better off putting additional effort into developing those assets and capabilities to provide greater or earlier revenue generating power for the intended buyer. A higher exit price will be achieved if the buyer can scale or replicate the asset or capability faster and can integrate the seller's business quicker. The only size consideration for the seller is to be

big enough to provide the launch platform for the buyer to fully and quickly exploit the strategic value.

Entrepreneurs need to be sensitive to these two types of ventures as it directly impacts the evaluation of the venture for Angel and VC investment and directly impacts on the manner in which the business would be developed for an exit.

A Compelling Investment Opportunity

Business advisors often talk about a compelling business concept and encourage entrepreneurs to create a venture which has high growth potential. They then assist the entrepreneur to build a business plan around the compelling business concept so that the entrepreneur can seek out investors to help them realize the business potential. However, what they have missed in all this work is that the Angel and VC investor is not that interested in the business, the product, market or what customers think of the product or service being developed or sold. What they really want to hear about is a 'compelling investment opportunity'. They want to be convinced that their investment funds will be used to create a successful exit event so that they achieve a great return on their investment. Their interest starts and ends with how the entrepreneur is going to make them money not produce the world's best widget.

The investor will approach the investment opportunity with a set of assumptions as to how the business will be developed and how the exit will be achieved. Almost without exception, those assumptions will include the following:

- The business is almost certainly going to be sold within 3-7 years. Outside a boom market, very few firms make it to an IPO.

- The entrepreneur and most of the equity holding management team are unlikely to stay with the business once it is sold to a corporate buyer.
- The investor, in most cases, will not be involved in the day-to-day operation of the business but will play a mentoring and strategic role.
- The investor can be expected to provide specific help in an aspect of the business where they have deep personal experience.
- A primary activity of the investor will be to ensure the business implements formal operational management systems and good governance processes.
- The investor will most likely hold at least one Board seat.
- The valuation of the business at the time of the initial investment has to take into account the risks associated with the investment and therefore is likely to be much lower than the entrepreneur thinks the business is worth.

One of the evaluation issues facing the investor is whether the business will have a financial or strategic exit. Clearly, the financial venture must be able to prove out an entire business model and be able to convincingly demonstrate a capability to produce significant growth in revenue and profit. This is in contrast to a strategic venture which must simply show that it is an ideal acquisition for a large corporation. While there are a number of attributes which both these ventures must demonstrate, the hurdle for the financial business is significantly higher.

For a financial investment to have a serious chance of being successful, resulting in an IPO or financial trade sale, it needs to show that it can demonstrate the *potential* to achieve the revenue and profit levels to provide a good return on the investment. In order to do so it is almost certainly going to have to satisfy some basic high growth potential criteria. These include the following;

- Clearly identifiable and reachable customer with a compelling need.
- An emerging and growing market with significant global potential which is fragmented and where demand exceeds supply.
- A business model with sufficient barriers to entry to protect the business over the first few years.

- A growth strategy which can achieve the levels of revenue and profit within 3-7 years to easily sustain the ROI needed by the Investor.
- A proven product or service which has clear customer acceptance.
- A management team which can demonstrate they have the skills and experience to execute the growth strategy over the next several years in conjunction with assistance from the Investor.
- A set of shareholders and a management team willing to sell the business within 3-7 years and walk away if necessary.
- A robust exit strategy with a high probability of execution within 3-7 years.
- A well-defined plan for the use of the investment funds which is directly linked to clear and measurable targets which in turn support the exit strategy.
- A robust business strategy and cash flow which can cope with things going wrong and can still, in the worst case, return the initial investment to the investor.
- A team willing to negotiate a realistic valuation.

For a strategic investment to be successful it must be able to show a highly probable exit through a strategic trade sale. In the assessment of a strategic venture, the business needs to demonstrate the *potential* to achieve the strategic sale. This means the business should display the following characteristics;

- Clearly identifiable and reachable customer with a compelling need.
- An emerging and growing market with significant global potential which is fragmented and where demand exceeds supply or an established market which would rapidly absorb the firm's product or service.
- A product or service with sufficient barriers to entry to protect the business over the first few years.
- A level of scalability or replication in the product or service which can generate significant new revenue for the strategic buyer in the first few years after the trade sale.
- A proven product or service which has clear customer acceptance.

- A management team which can demonstrate that they have the skills and experience to execute the strategic trade sale over the next several years in conjunction with assistance from the Investor.
- A well-defined plan for the use of the investment funds, which is directly linked to clear and measurable targets which in turn support the exit strategy.
- A robust business strategy and cash flow which can cope with things going wrong and can still, in the worst case, return the initial investment to the investor.
- A set of shareholders and a management team willing to sell the business within 3-7 years and walk away if necessary.
- A team willing to negotiate a realistic valuation.

You might argue that it is near impossible to find an early stage venture that meets either of these sets of criteria. Your proposal to the investor should be able to demonstrate that you can satisfy one of these business models. You need to convince them that you and your management team can take them to a successful exit.

Angels and VC investors generally invest where they can see that the venture can be developed over a few years to the point where it can be sold to a corporate buyer or taken to an IPO. Your task as the entrepreneur seeking investment funds is to convince the investor that, with their funds and assistance, you can develop the business to achieve the desired exit.

Your investment proposal will need to show that you understand what the investor wants in an investment opportunity and that you have a business venture which will satisfy their objectives. In setting out your business venture you will need to examine a number of areas of the business to show that you can meet their investment criteria.

The market analysis

There are many marketing texts that you can read which talk about market segmentation, customer buying patterns, pricing models and so on. Most likely the Investor will have read those and so understands the jargon. The key to

an investable business is more about the execution of a business plan over a limited period of time to achieve the exit conditions. This might be a stated level of revenue and profit, rather than developing a sophisticated marketing plan for market domination. Alternatively, it might be in preparing a product or service for a strategic buyer's market. If the life of the venture is to be 3-7 years before an exit, then very specific targets need to be achieved.

Whether it is the target market of the venture or the target market of the strategic buyer, it can be expected to have the same fundamental attributes. The target market definition needs to be very simple, robust, obvious and easily proven. The ideal model is characterized by the following:

- Well-defined, identifiable and easily reachable customers who have a high compelling need to buy, a willingness and ability to pay the price and are in sufficient numbers that the revenue targets can be readily achieved.
- A segmented market where it is possible to significantly differentiate the product or service from competitors and where that differentiation is difficult to copy or neutralise.

A financial venture would also need to be able to demonstrate the following:

- A total market which is growing, has global potential and would be attractive in the long-term to a major corporation.
- A fragmented market which enables growth by acquisition.

The customer

The better business to be in is where the business has a list of all possible customers for the product or service. Alternatively, the customer can be readily reached through an established, or readily built, distribution channel. The investment proposal should be explaining:

- the profile of the ideal customer
- how contact will be established
- what their buying pattern is
- how they have the purchasing power to readily meet the sales price.

You see businesses all the time which reach out to the general public in the hope that they will buy. A retail store, a restaurant and the internet marketing firm are all hoping they can attract customers. But they have little influence over the buying cycle. On the other hand, customers which can be clearly identified, named and are able to be approached with a value proposition are much easier to sell to. This is not to say that other models are not successful, however, they generally carry a greater risk.

The compelling need to buy

Few people understand just how hard it is to build a value proposition which compels a customer to buy. Most products are chosen on a whim, can be readily deferred or have many alternatives and substitutes.

Example

Distinction Software Inc. a business established in 1994 in Atlanta, USA, by Dr. Tom McKaskill developed a sales forecasting and inventory planning system for high volume, low cost consumer packaged goods. Using prospect data the software could show a 15-30% reduction in safety stock over a three month period providing an investment payback of 3-6 months on the software cost. Even though many corporations expressed interest, few made the investment. Why?

After five years it became apparent that only corporations that had deep-seated inventory problems were willing to make the organisational and system changes to implement the software. For the others, their profitability was high enough that the changes required to implement the software were simply 'too hard'. For the software to work effectively the customer needed to change job responsibilities, reporting lines and data ownership. The 'compelling need to buy' only existed in a few corporations. For the others, it was a desirable, but not necessary, thing to do.

Think about these questions:

What problem is the venture solving?

Is it satisfying a need or a desire?

What degree of compliance (penalty or cost) results from not buying?

What happens if the customer does not buy?

Are there alternatives to the firm's product or service?

Who is required to solve the problem? What happens to them if they don't?

Market characteristics

Historically, most investors have preferred their investee companies to operate in medium-sized global markets as this will ultimately attract the corporate acquirer or will be the basis on which to launch an IPO. Investors now are much more attuned to the need for an exit event and so for them, it is not whether the market is small or huge, it is simply whether the target market over the next 3-7 years can provide the firm with the capability to achieve the valuation required for the investor to exit. In the end, it all comes down to valuation on exit and ease of exit. The target market may be directly addressable by the investee firm or could be the target market of a strategic buyer.

For a financial venture, a larger fragmented market where new products and services can find a reasonable size niche market are preferred by investors as this is easier to achieve than global domination or a share in a commodity market. The firm has to demonstrate in its investment request that it can secure the level of revenue and profits required to achieve the valuation target. Even in a very large market, a lack of customer demand for the specific offering of the firm won't make the target numbers.

For a strategic venture, it is whether the potential strategic buyer has an existing market which can be readily addressed or a potential market which they can exploit.

Basically the entrepreneur must establish, with a reasonable degree of certainty, that the revenue, cash flow and profit targets of either the firm itself or the intended buyer can be achieved. This requires a very good understanding of the marketplace, an understanding of the needs of the customers and some level of proof that customers will buy in the quantities forecast. This might be based on existing sales, prospect surveys or expert advice plus experience within the executive team.

However, in order to show a probable exit path, the requirements of the exit strategy need also to be shown. An IPO requires the company to confidently build to, say, a \$100 million valuation within three years after listing. Smaller companies are not excluded from an IPO, in fact many companies smaller than \$100 million are successfully listed; however, they tend to miss out on attracting institutional investors and in many cases do not attract broker coverage, accordingly, they present a greater risk to maintain or increase values. Furthermore, as the management team and the Investor usually have at least part of their shareholding escrowed for a period of time, the exit value may ultimately be at prices below the initial listing price. For an IPO exit the firm needs to confidently show that it can achieve the revenue, cash flow and profit targets needed to support the share price over a 3-5 year period after listing. With an IPO exit, hopefully funding through the IPO and subsequent rounds of public capital raising will fund growth. The business needs to have a very strong product/market position to fuel growth.

For a financial trade sale exit, the requirements for revenue and profits are very different. The firm need only show that it can reach the level of revenue and profits needed to close the trade sale deal. In the case of a strategic trade sale, revenue and profit targets could be zero or limited, that is, the deal is based on some other aspect of the business which needs to be achieved, such as a product development stage. At other times, the acquiring corporation may want to see a limited number of customers actively using the product as a proof of design, marketing and operational use.

In many cases, corporations enter into a strategic trade sale with an emerging firm to acquire a product which has considerable global potential. In proposing a trade sale exit strategy, the firm needs to convince the investor of the ultimate size of the market which would attract the proposed buyers, whether they be a financial or strategic buyer. Thus market size and competitive positioning become important, not for the short term, but to secure the ultimate acquirer.

You should explain the structure of the industry and show an analysis of the market dynamics to demonstrate the business or product potential.

Which companies are growing and why?

Which firms are declining and why?

Is this an emerging market where demand exceeds supply and thus even poor businesses will survive?

Given the product positioning, which market is the firm attacking and what retaliation, if any, can the firm expect from the current players?

Is this a market which will attract new entrants and, if so, how will the firm defend its business from the new competition?

Competitive analysis

Angels and VC investors prefer their investee companies to sell products or services which are differentiated from their competitors. They like to see differentiation based on some level of innovation in product, process or business concept. The innovation itself needs to be difficult to match over the period of time needed to achieve the exit target.

If an IPO is planned, the product needs to be sufficiently different to be able to sustain a long-term competitive advantage. This is the only position which will allow the firm to achieve the revenue, cash flow and profit levels needed to sustain the share price in the public market.

In a financial trade sale, the firm has to be able to demonstrate revenue growth into the medium term. Competitive advantage is going to be a key aspect of the business case to the buyer.

For a strategic trade sale, competitive position is not as important as being the right product for an acquisition. However, if you look beyond the acquisition, you have to deal with the competitive position of the acquiring corporation and the subsequent merged operations. This means the investment proposal needs to show how the acquiring corporation would use the firm's products to secure significant revenue. Although, this may be in combination with the acquirer's other products or by selling the firm's products into their own customer base.

The competitive analysis needs to show very clearly why the firm's products are preferred in some market segments and to demonstrate reasonable proof of that assertion.

Barriers to entry

Whatever the exit, the future generation of revenue and profit will require the firm to establish that its products or services which drive revenue generation and have a level of competitive advantage which itself has a significant degree of sustainability. This implies a reasonably high level of barriers to entry.

There are two fundamental questions which the entrepreneur needs to answer:

Why would customers buy our products or services?

What is to stop a competitor from taking the business away from us?

The first question should be supported in the proposal by the product value proposition, a market analysis, a competitor analysis and the compelling need to buy. 'Why you?' is also an issue of credibility. The firm or the strategic buyer needs to be able to convince the target customer that they can trust it to deliver and support the product. In the case of the investee firm, establishing the product or service in the market may be achieved through the experience of the team, from existing customer testimonials or through customer trials.

The second question is simply about protecting the business from erosion from existing or new competitors. What is to stop a much better funded, larger, more aggressive competitor from duplicating what the firm has done and offering greater incentives for their prospects to buy from them? This gets down to: how is the firm or the strategic buyer going to protect its business?

Protecting the business is achieved by erecting barriers to entry. What can the firm or the strategic buyer put in place to protect its competitive advantage, distribution channel, ongoing customer revenue and source of supply.

Barriers to entry have one, or several, of the following attributes:

- high start-up costs
- expensive to acquire
- takes a long time to acquire
- protected by patent, trademark or copyright
- restricted under licence, rights or agreements
- requires specialised knowledge which itself is in limited supply
- highly innovative and not capable of reverse engineering
- protected by ongoing customer revenue through high switching costs or contracts
- ownership of or contracted distribution channel
- restricted or contracted source of supply.

Strong barriers to entry usually create the basis for a sustainable competitive advantage. This is also the foundation of any longer term growth strategy for a public listing. A strategic buyer will need to be convinced that these conditions can be established by it subsequent to the acquisition.

The management team

The literature in the venture capital area is dominated by the quest for the 'A team'. This is the super team. The 'A team' has done it all before and has the skills, capabilities and diversity to cope with anything under any conditions. Regrettably they rarely exist and Angel and VC firms have to put up with business plan presentations from ordinary mortals.

However, that is not to say that their objective is wrong. It is simply that executives who have done it before have probably learnt from their successes and failures. They are well connected in the industry and are knowledgeable of other experienced executives and can easily recruit additional team members. For the Angel or VC investor, it is all about reducing risk. If they can invest in a well-rounded team with experience, they have a greater chance of achieving their minimum targets.

The 'A team' also brings with them the following:

- a knowledge of Angel and VC investment requirements
- willingness to negotiate a realistic valuation
- experience with an exit
- not as emotionally attached to the 'product'
- networks within the industry and with potential alliance partners.

For the Investor, members of an experienced management team are easier to deal with and have a good understanding of the funding process.

Although the venture capital market has been operating in Australia and New Zealand for more than 20 years on a formal basis, there are still very few experienced management teams which have gone through a formal private equity investment and exit cycle more than once, unlike the US and European markets which have floating management teams which move from one investment with an Angel or VC firm through to an exit and on to another investment.

Many of the deals brought to the Angel or VC firm for funding simply lack an experienced set of executives. There can be no question the entrepreneur brings the idea, the passion, the vision and the energy, but other team members usually make it work.

When the investor looks over the business plan, they are working on the activities which need to be executed to deliver the critical targets. This might be sales, marketing, product development, quality control and so on. For each of these activities, they want to know who on the team will deliver this operationally.

The real test to be applied here is operational. Given where the business is today, can the team execute, with reasonable confidence, the activities needed to get them to the exit conditions within the 3-7 year period? In some cases the investor will be making a judgement as to their own impact on the ability of the firm to achieve such results. So the fundamental question which the investor has about the management team is: 'Can the team and I together achieve the targets needed to exit?'

For most exits, this will be a trade sale and the management team may not be needed beyond that. Not all proposals need the 20-year veteran or the executives recently cashed out from their IPO. In fact, this may be the wrong team for a clearly defined trade sale exit.

The business proposition also needs to show who is going to deliver on each of the major activities needed to reach the exit conditions. Any weakness in the team will need to be addressed by the investor. The management team can be supplemented with experience from a Board of Directors, a Board of Advisors and external consultants. Where the management team is not complete, the Investor will want to see an acknowledgement that the existing management recognise this deficiency and accept that new talent will need to be recruited to deliver on the business targets. Some of the founding shareholders may have to step aside. This is a critical time for entrepreneurs as they need to put together a team which has a high probability of meeting the targets.

Operations

Day-to-day monitoring of the business is an essential characteristic of a well-run firm. The firm has to know where it is, what it needs to do and have the systems, policies and procedures in place to monitor and correct deficiencies. The reason why Angels often become involved in early stage ventures is because it is this experience they can bring to the venture. From their past experience with start-up and high growth revenue ventures, they have learned the importance of being well informed and taking remedial action early.

Operational systems include all the budgeting, financial and operational reporting systems, performance setting and monitoring processes, and systems and reward schemes which encourage the right behaviour. High growth

businesses are finely tuned because they consume cash in building capacity. They have little room for mistakes and therefore early warning systems and quick response systems are very important.

At the same time, the business must manage its contractual risks. Well written contracts with customers and suppliers, well-designed contracts of employment, well documented intellectual property ownership and assignment are all components of good management of risks.

Product development

It is unlikely that an investor will ever know as much about the product as the entrepreneur and his team. Even if they have a technical background, this can be out-of-date quickly and they are rarely in a position to adequately judge the quality of the product development systems or the reasonableness of the timescales. This is therefore a high exposure area for the investor. To overcome this limitation, the entrepreneur will need to show adherence to budgets and targeted timescales, or show how the available products are capable of producing the results required. The entrepreneur must accept that keeping development costs under control and meeting development timescales is critical to ensuring the investors ongoing financial support.

Later Stage Investments

More mature firms with established management, proven products and demonstrable revenue streams, often seek funds for market expansion, filling out product portfolios, acquisitions or working capital. Such firms offer a very different risk profile to the private equity investor compared to a start-up or early stage venture. However, such investments are not without their risks.

Firms often seek external private equity finance because they don't have the tangible assets needed by traditional banking lenders. Thus the 'assets' which underwrite the funding are often 'soft', such as patents, brands, copyrights or simply a good business model. As such, they are harder to value and often hard

to liquidate. Even so, they may be good revenue generating assets and can provide some level of comfort to the investor.

The investor is still concerned with an exit. He will need to balance two opposing concerns, the upside potential of the business and the risks of failure. The upside opportunity will be presented in terms of building market share, establishing overseas offices and penetrating existing markets with additional products. However, the risk will be in the execution. Does the team have the skills and experience to deliver the target numbers? Will the market support their growth?

With more mature enterprises, the investor has a much greater body of evidence to examine how well the company performs strategically and operationally. The investor will still need to conduct extensive due diligence to uncover any weaknesses or risks. Established products and relationships can be examined to determine market potential and service excellence.

Many entrepreneurs seek finance at this level to provide a boost to their business so they can reach a size and profitability where they can convert equity to debt or take the company to an IPO. This recapitalisation enables them to gain larger critical mass while at the same time gaining back the equity passed to the investor as part of the financing deal. The entrepreneur is betting they can generate the level of security needed to fund debt within a relatively short period of time (3-7 years) to take out the investor.

Entrepreneurs are often reluctant to part with equity, seeing this as loss of control and/or loss of upside potential. However, a deal which allows the entrepreneur to redeem the investor's shares at some agreed formula can be a very attractive method of building up the business with an opportunity to buy back the external equity. Expansion finance which is used to build up tangible assets, decrease revenue and profit volatility or increase the portfolio of revenue sources, can provide a platform for negotiating debt to repay an investor.

Entrepreneurs interested in short-term equity investment with redeemable options need to have a clear focus on the security requirements for debt finance. These factors then need to be built firmly into the business plan with the agreement of the investor. Even partial redemption, swapping some equity

for debt, during the investment period, may be an attractive option for both parties.

However, the entrepreneur still needs to accept that there is a potential pitfall in bringing in an investor. An investee firm which fails to meet agreed targets or fails to generate sufficient free cash to fund debt obligations is still subject to intervention by the investor. The investment agreement would normally allow the investor to take action if the investment is in trouble. No business is entirely free of risk, even if this is external to the firm and even to their marketplace. The entrepreneur seeking later stage financing cannot guarantee they can recapitalise or take the business to an IPO. Failure to provide a liquidity opportunity for the investor will result in intervention by the investor to ensure that there is an exit opportunity while the business still has real worth. This will often result in the firm being sold in a trade sale.

In more mature businesses, the investor is likely to play a very different role than that undertaken in early stage ventures. Where early stage ventures typically need advice and direction in moving the business to profit, growth and sustainability, later stage businesses often only need help at the Board level. Their needs are more likely to be advice on strategy and creating the right foundation for an IPO or major trade sale. Good governance, good reporting systems and a structure which reduces internal risks need to be developed. Investors in larger ventures often assist with global expansion, help establish strategic relationships and assist with VC rounds.

The Investment Proposal

Any request for Angel or VC finance should have a comprehensive business plan. It is not that the investor could not understand the business from a discussion or presentation, it is just that it is more efficient in the long run for the entrepreneur to have it all documented in advance. The investor can then reject it with a quick glance at the executive summary, review it prior to a meeting, use it to open discussions with other co-investors and use it to drive the due diligence process if they wish to proceed.

The general view is that, if the entrepreneur cannot put together a good business plan explaining every aspect of their business, they probably don't understand the business well enough to grow it to the point the investor desires. Part of the entry test for investment is that the entrepreneur have the necessary literacy, numeracy and communication skills to run the business. The business plan is one of the tests they need to pass.

The major benefit to the investor of the business plan is to provide an opportunity for the management team to demonstrate they can build a model of the business which an outsider can understand. The model needs to be holistic. It has to explain every aspect of the business in sufficient detail to show that they understand how all the parts have to work together over time.

The investor is being asked to invest considerable funds in a business which they are trying to understand. It is unlikely that they will ever understand the business as well as the entrepreneur and the management team. Since the investment is only for a short period, say 3-7 years, they need to see a strong possibility of a trade sale or an IPO during that time. What the entrepreneur needs to demonstrate in the investment proposal, in non-technical terms, is that he or she can achieve those objectives.

Most business plans are simply projections of the past. It is simply Excel madness. It is almost as if, by putting the data into Excel and projecting it forward for three years, it will happen. Of course it may. But that would be more hope than strategy. Forecasts need to be based on a set of realistic and defensible assumptions. For many entrepreneurs, the business plan is an expression of what they would like to happen. They work backwards from what they would like to happen to establish the growth rate that will get them there. Alternatively, they use a set of assumptions which seem reasonable and build their business plan on those assumptions. This is often presented as the classic 'percentage of the market' plan: 'The market is huge and we only need 2% of the market to be a \$100 million business.'

However, most often this is not supported by any validation that the customers will buy the firm's products or that they will buy in the volumes asserted. The business plan needed by an Angel or VC firm has a very specific purpose. It is to

convince the investor that the firm can deliver the objectives they have for the use of their money. Put simply, that means:

- a 25% plus ROI
- known expansion opportunities
- an exit via an IPO or trade sale in 3-7 years
- identified potential trade buyers
- limited support required
- relatively low risk.

Many entrepreneurs think the purpose of Angel or VC finance is to help them grow their business, or they think that the investment is simply another form of finance that will help them overcome some constraint within their business. What they fail to appreciate is that Angel and VC finance is specifically designed with certain objectives in mind which can only be achieved by developing the business so that the investor can achieve a good return on their investment usually through an exit event in a relatively short period. The purpose of the business plan is to prove that those objectives can be met.

The business plan the entrepreneur needs to produce should have the following three components:

Where is the venture now and what is the growth opportunity?

What is the exit strategy?

How are they going to achieve it?

The business plan should also include details of the management team and their capacity to deal with the business development strategy along with the how the funds sought are going to be utilised in support of the business objectives.

Where is the venture now?

The entrepreneur should have a well-articulated business opportunity which needs Angel or VC finance in order for it to be achieved. So the first part of the

proposal for Angel or VC finance should be about the business opportunity and the extent to which it has been validated.

It is almost always going to be the case that the entrepreneur will think only in terms of building a financial business. They will seek to generate significant revenue and profit to justify the Investment. It is highly unlikely that they will have thought of an IPO or a Strategic Trade Sale exit or be able to show how this could be achieved. Their inclination will almost always be to prove a traditional business model concept. What they need to do is to switch focus and show how the exit will be achieved.

The proposal should demonstrate the strength of the growth potential of the underlying product or service as this will be critical for an IPO or trade sale exit. The entrepreneur should be explaining the following :

- What is the business concept?
- What is the size of the target market and how will the firm secure its share?
- Who is the customer?
- What is the benefit to the customer and where is the compelling need?
- What price and why?
- How is the product or service distributed to the customer?
- What is the competitive advantage?
- How is sustainability of the business achieved?

If the business is already operational, the existing business should be able to demonstrate the operational aspects of the business model. This should validate the product/market information, the financial aspects of the business and the management team's capabilities. If there is a strategic exit opportunity, this information may deal with how the strategic buyer would execute on some of these elements.

In summary, the investor needs to be convinced that this is a good business with a good idea or strategy, is well run and has a good chance of achieving the financial or strategic exit required.

What is the exit strategy?

Most Angels and VC firms have similar objectives for their investments. While they enjoy the involvement with emerging companies, they want their money back with a 25% plus ROI within 3-7 years. Therefore, the investment proposal should clearly set out how much Angel or VC finance will be needed and how the investor will achieve that objective.

The investor needs to know which exit strategy is being proposed and why. Potential multiple exit opportunities are even better as they bring flexibility and reduced reliance on equity market cycles. The vast majority of firms simply cannot meet the attributes of an IPO. For others, the IPO strategy cannot be met with their existing business model and it will take a number of acquisitions to create the right IPO vehicle. Only very few will have the right mix of products, markets and potential to undertake an IPO and also meet revenue and profit targets for several years beyond. Since an IPO generally achieves a much higher ROI than a financial trade sale, the IPO strategy should be followed. However, a trade sale alternative should be articulated in the proposal for periods where the market is unreceptive for an IPO.

For the tradesale exit, the entrepreneur should be setting out a comprehensive road map for how the sale will be achieved. This should include identification of specific potential buyers, the tactics which will be employed to develop relationships with each and an estimate of the likely sales price.

How are you going to get there?

The business plan is simply about execution. The business is at point A (now) and it needs to get to point B (the exit), what are you proposing to do to get there? You need to set out exactly how you are going to put the strategy in place over the 3-7 year timescale.

Some Angels prefer to keep it simple. Knowing that the management team is somewhat green and need help to develop the business, they need to ask:

Exactly what are you going to do with my money?

Say you are a \$1 million revenue business. To get to the exit point, you may need to grow the business to \$4 million. Alternatively, you may need to complete product development or establish trial customers to prove the product. How are they going to do it? It is not simply an extrapolation of the numbers. You need produce operational plans for every part of the business.

- A detailed marketing plan
 - Size, growth, customer profile, competition
 - Promotion, advertising, PR plans
 - Proof of effectiveness
- A sales plan
 - Closure rates, remuneration plan
 - Recurring business revenue and targeted prospects
 - Sales targets and recruitment and training plan
- An R&D plan
 - Product development and release milestones
 - Quality assurance, recruitment and training plan
 - Equipment plan

And so on.

There is nothing wrong with an entrepreneur admitting they need help to develop such a detailed plan, but the investor is likely to delay making any substantial commitment until a proper business plan is in place, even if they help develop it. Only by getting down to this level of detail will you understand just how much finance and effort you need, but also, just how likely the business is to succeed.

Before committing to the investment, the investor will need to review every part of the plan and see exactly what each manager will be doing to contribute to the overall plan. The business plan should also set out an organisational plan (including recruitment and training) and plans for office accommodation, manufacturing and warehousing space, infrastructure and finance. A set of projected financial statements should be available.

An investor will ask; 'Show me exactly how these revenue numbers are going to be made?' They may want to see a breakdown of forward revenue projections for both recurring revenue and new business. The recurring revenue should be supported by actual contracts with customers. The new business should be supported by a prospect generation and sales closure plan that targets specific customers or specific channels and so on.

The more you can show you really understand how to make the targets and you have the people, systems and processes in place to do so, the more convincing your plan will be.

At the same time, the growth plans may call for new management positions to be filled, in which case an executive recruitment plan should be included in the plan.

Which business plan layout

There are many examples of conventional business plan structures in textbooks and on the internet. Those offered by VC firms are good guidelines for the content. However, it is the way it is put together that is important. *Remember that the business plan should be about how you are going to meet the investor's objectives, not how you are going to meet yours.*

For an insight into how a typical VC business plan might be structured, review the description provided on the British Venture Capital Association website in the document *A Guide to Private Equity* (see <http://www.bAngela.co.uk/>).

Exit Strategies

There are two major paths to a successful exit of the firm. One is to sell the firm. This might be to another business (trade sale), usually a corporation in a similar or related field or to another Angel or VC Fund (secondary buy out), or to a wealthy individual. The second path is to list the firm on the stock exchange, an initial public offering (IPO).

Initial Public Offering

The requirements for listing a firm are quite onerous and expensive. Unless the listing results in a share price which can maintain a position at least as good as the sector index, the listing will not achieve an exit the shareholders anticipated (assuming the shareholders hold shares in the listed company). Just having liquidity of the shares via a market listing does not in itself guarantee the value achieved by the shareholders will be greater than an outright sale to a corporation.

Some private companies undertake an IPO, or a back-door listing (acquire an existing but dormant publicly listed corporation), with the intention of using it to raise funds or to sell shares. Typically, back-door listings are done with smaller companies. However, unless the size of the shareholding in public hands is significant, generally thought to be above \$100 million, there is insufficient liquidity to create a market to sell shares.

The table below shows the types of characteristics which best suit an Initial Public Offering (excluding speculative ventures such as biotechnology and resource ventures).

Attribute	Requirements for long-term attractive public listing
Revenue	\$20 million plus (\$100 million plus the most successful).
Net profit	Profitable for three years with minimum of \$2 million in the year prior to listing. Projected profits growing over next few years.
Scope	National or international markets.
Portfolio	Range of products with some in different markets.
Potential	Major national leadership or global markets.
Management	Majority with public corporation experience and some with experience in larger corporations.
Board	Significant industry and public corporation experience.
CEO	Able to deal with market analysts, institutions and shareholders.
R&D	Products in various stages of development to ensure continued market leadership.
Cash	Sufficient funds to meet forecast plans without further capital raisings.
Funds use	Funds raised to be used for market development, innovation, overseas expansion, acquisitions, working capital, repayment of debt.
Advantage	Clear competitive advantage based on strong intellectual property and/or proven innovative business model.
Public awareness	Products and their benefits are easily understood by the public.
Support	Listed shares are large enough in value and number in institutional and public ownership to encourage market analysts to track the stock. Generally this means a market capitalisation of at least \$100 million.

Since few companies in private ownership can meet these requirements, an exit strategy aimed at an IPO is not a viable option for most privately held firms. That is not to say the smaller companies cannot exit through an IPO, but the above provides the best foundations for success.

Generally it will take a minimum of \$500,000 in legal and accounting expenses for even the smallest and simplest IPO. According to KPMG Corporate Finance's 2004 Australian Capital Markets survey, the average cost of raisings up to \$10 million was 10.1%, falling to 4.7% for raisings greater than \$500 million. If only a small amount is to be raised, this cost is very high for the funds received. At the same time, an IPO usually involves significant work for the top executives. This has often been thought to be 50% of the CEO and CFO's time over the six months prior to the IPO. This is a very significant burden on the firm and requires the rest of the management team to bear the burden of day-to-day management during this time. A USA listing would be more expensive in annual expenses due to the greater disclosure requirements.

The overall consensus of private equity advisors is that only four factors are considered key to a successful IPO. The first factor is the venture should have a strong competitive advantage and sufficient growth potential to achieve a \$100 million capitalisation value within about five years of listing. Neither the current level of revenue or profit is considered significant compared to anticipated revenue and profit. This factor also goes a long way to explaining why low growth firms which have low margins either don't make it to the exchange or have to be significantly larger before they can.

The next major factor is the depth and experience of the management team and the industry experience of the Board of Directors. Again this is not surprising when you consider that the shareholders are backing a group of individuals to take them to the size necessary to support the \$100 million capitalisation. A new management team or one which has significant technical depth but little management depth is not going to be received well.

Knowledge of the IPO process itself by the management team is a major factor. This demonstrates just how important the roadshow to the brokers and the presentations to institutional investors are. Achieving significant share purchase commitments up-front is almost a necessary condition for a float. Knowledge of retail and institutional investor risk and return requirements and being able to convincingly show growth potential is an imperative. Investors are typically risk-averse and will quickly zero in on potential risks in the venture. The management team must be able to convincingly demonstrate knowledge of their business, their industry and how to mitigate possible risks.

Finally the firm must have the best possible advisors. The best advisors and investment bankers are expected to have the best due diligence processes, require the highest standards of preparation but also carry the highest level of credibility to the market. They are also very selective in who they represent.

Too many entrepreneurs see an IPO as a means of solving their own business problems rather than seeing it as a means where retail and institutional investors achieve a return on their investment. Without gaining the support of a significant number of retail investors and/or support from some institutional investors, the firm is likely to push themselves onto the market by satisfying the minimum listing conditions and then find that just being publicly listed does not solve their inherent problems. As we have seen many times – the market penalises those which don't perform. In many cases, these firms would have been better to wait until they had more robust growth potential before listing.

It may not be possible for the major shareholders to exit at the time of the IPO or even within some years. Markets are very wary of public issues where the key managers sell off their shares completely. In a situation where the results are not achieved subsequent to a sale of shares, the inside shareholders could also face legal charges of insider trading.

A firm which wants to undertake an IPO exit needs to build the IPO profile above. So, to the extent that it cannot meet the requirements within the existing business, the additional attributes need to be developed or acquired. With 3-7 years to execute the IPO strategy and especially with Angel and VC financing, a firm may be able to achieve the necessary characteristics given the right starting point. Many companies which attract funding have already identified strategic acquisition opportunities to bring economies of scale and growth to the company.

In some sectors, building a company via acquisitions is a possible strategy. Certainly in the years 2002 and 2003, firms in the biotechnology sector in Australia needed to undertake consolidation to gain additional resilience, product portfolio spread and critical mass. Too many biotechnology firms were undercapitalised, had very narrow product ranges and too little revenue spread from licensing to longer-term production products.

Often in emerging markets there will be several firms with complementary products, often selling to the same customers or working with the same alliance partners. These could be brought together to provide a platform for an IPO vehicle. However, there needs to be an obvious and demonstratable synergy between the products and the firms. Just lumping a number of firms together to reach the revenue and profit targets is unlikely to convince the institutional investors they are investing in a sound platform of future growth.

At the same time that the underlying product portfolio is being built, the firm needs to construct a management team capable of running a growing public corporation. Public corporation experience, experience with larger corporations, deep experience in the industry and a good track record, are all essential characteristics for the IPO management team.

The IPO strategy needs to show, in considerable detail, how the IPO prospect profile will be achieved. Underpinning the plan should be documented representations from respected accountants, lawyers, bankers and brokers who are willing to work with the firm on building the IPO strategy.

Trade Sale

Most Angels and VC Investors exit or harvest their investment through a sale to another firm. This is called a trade sale.

Where possible, the Investor will seek a strategic trade sale to order to meet or exceed their return on investment (ROI) needs. A strategic sale occurs when the value placed on the business exceeds its fair market value (FMV). The FMV is most often determined by looking at the current business as an investment by an independent investor looking for a return on their money. The current profit is taken as indicative of the ongoing profitability of the firm and ROI. Since few owner/managers operate the business to maximise profits, this will normally undervalue the business.

A conventional sale based on an EBIT multiple would certainly be attractive to an Investor if a strategic sale was not possible. In that situation, attention needs to be given to increasing operating profit, decreasing risk and establishing a growth potential in order to secure the best price.

However, normally a strategic sale can be expected to achieve a sale price considerably above a conventional sale price. The key to a strategic sale is to find a corporate buyer which has a need for the assets and/or capabilities of the firm. This strategic fit can come from any number of possible areas:

- customer base
- distribution channel
- brands
- patents, trademarks, licences
- key employees
- access to specialised knowledge and so on.

Strategic buyers most often come from within the industry in which the firm is operating. They can be suppliers, customers, alliance partners, joint venture partners or competitors. Sometimes the sale will be to a corporation not in the sector. They may want to acquire a presence in a market/geography as a foothold or may wish to diversify.

The Proactive Sale Strategy developed by the author defines a process which can be used for financial and strategic trade sales. This methodology has five major components:

- alignment of interests
- due diligence and good governance
- creating value for the buyer
- selecting buyers
- building relationships with potential buyers.

(a) Alignment of interests

In order to be prepared for a trade sale, especially when there is time pressure to set up and consummate a deal, the various stakeholders need to agree on the possible outcome. There is little point in progressing a deal if the Directors cannot agree on what they want, or the shareholders cannot agree on a reasonable price. A negotiator cannot go into a meeting to secure a deal if the interests of the major stakeholders are unclear. Experienced Investors usually have the Board focused on exit strategies from the first Board meeting.

The major stakeholders who are critical to executing a deal are:

- members of the Board of Directors
- management
- Investor along with other shareholders
- key employees.

The Investor needs to ensure that all stakeholders are focused in regard to the two extreme situations: a forced sale due to decline in the viability of the business or a planned sale over a longer term. Once the CEO has a list of requirements, opinions, conditions and issues which need to be considered, he/she can start to bring all elements together to arrive at a strategy which could be followed in these two extreme situations.

(b) Due diligence and governance

Nothing kills a deal quicker than an uncertain or immeasurable risk. Many people think the valuation on sale is due simply to revenue and profit. What happens in practice is the buyer conducts an extensive due diligence into every aspect of the firm's operations in order to uncover actual or potential problems, risk and liabilities. Since each of these requires time and funds to resolve, the offered price is likely to fall as the review goes forward. At some point the risk, time and cost to fix the problems become so great that a deal is not possible.

The task of the Board from a directional perspective together with the CEO from an operational perspective is to establish the firm and its operations to minimise risks to the buyer. This includes putting into effect such things as:

- Standardised and documented contracts with customers and suppliers.
- Industry standard terms of employment, benefits and entitlements.
- Full ownership and tracking of intellectual property.
- Full compliance with industry, health, safety and environmental regulations.
- Comprehensive reporting, budgeting and planning systems.
- Policies, procedures and processes covering critical aspects of the operations.
- Industry knowledgeable accountants and lawyers.

The key to passing a business to a buyer is to put yourself in the buyer's shoes and think through the integration and operations of the business after the acquisition. The task of the CEO and management team is to ensure that the business can operate effectively after the acquisition without imposing an undue burden on the buyer.

Included in the planning for a sale should be a consideration of the roles of the key employees. In most acquisitions some roles will change, some staff will be made redundant and some key employees are needed to ensure a transition of knowledge. How can you ensure that this process happens without disruption? This means determining retention terms for some, redundancy packages for others and incentives for all staff to make the transition happen as smoothly as possible.

(c) Creating value for the buyer

In a financial exit, the firm needs to create value through the generation of future net earnings. Preparation for sale would focus on improving internal processes, reducing expenses, increasing revenue and margins, adding revenue growth and then seeking out opportunities for potential growth.

Strategic acquisitions occur because a corporation has a need for some asset or capability which the firm has. Generally this is something which the firm already leverages to create its own competitive position. As part of the Strategic Sale Strategy, the Entrepreneur needs to think carefully through the operations of the business and isolate those things it has and those things it does which could be used by a large corporation to resolve a threat or generate significant new revenue.

Assets or capabilities which create strategic value should be based on one, or several, of the following characteristics:

- difficult or time-consuming to copy
- protected by patents, trademarks or copyright
- only available through licensing or registration which is limited in supply
- unknown due to confidentiality or trade secrets

- requires specialist knowledge to acquire or utilise

(d) Selecting buyers

Financial buyers are often corporations undertaking a roll-up or consolidation strategy. They are looking for well managed firms in their sector which can add revenue and profit to group earnings.

A strategic buyer is a corporation which is prepared to pay a premium over fair market value because the business solves a critical problem for them or offers them a good opportunity for additional revenue and profit. The best strategic buyers are ones which can exploit an opportunity by offering a unique product on a much larger scale than the firm is able to with its limited resources. The Investor should look for corporations which can overcome whatever constraint is holding back the business.

Buyers normally come from within the industry, so start by listing companies in the same industry as the investee firm. You then need to select those companies which have the capacity and experience to do the deal. Corporations with experience at acquisitions and which have ample size and funding are much easier to deal with. The ideal buyer will typically be at least 8 times the size of the seller.

(e) Building relationship with potential buyers

Trade sales are mostly made between parties which already have some knowledge of each other. This could be informally through networking functions, between prior colleagues or could be a formal trading relationship such as a partner or distributor. Other relationships can exist through Boards of Directors or Boards of Advisors or equity participation. The key to a trade sale for an Angel or VC funded company, as with any other company, is to be prepared.

Any early stage venture is going to experience some turbulence and not everything will go according to plan. In terms of exit preparation think of the situations you may experience.

1. You need to sell

Not everything is going to go according to plan. Sometimes market conditions change and the business is no longer capable of reaching the targets initially set or may no longer be viable. Rather than let the firm become insolvent or bankrupt, the exit plan should be established early so that there is little delay in executing a trade sale. This way the maximum benefit can still be extracted from the failing business.

Often time is against you. If the management team has not put an exit strategy in place, they will have little time to prepare or to initiate discussions with potential buyers. If they have not set up the relationships in advance, especially with overseas buyers, it probably is not going to happen the way you would like. Without planning, the ability to attract a buyer who will pay a premium value for the company is significantly constrained.

By setting up relationships in advance and by knowing why the corporation would want to buy the firm and who to deal with inside the potential buyer, management can execute the acquisition discussion quickly. As long as the firm has several potential buyers, competitive tension in the deal can still result in a very attractive sale price.

2. The firm is approached with an offer to buy

Many Angel and VC funded firms are targets for acquisitive corporations. However, when the offer comes management may be unprepared. They are often unsure of an appropriate price. If management is unprepared and needs to go through extensive due diligence, this not only takes considerable time, but it uncovers risks to the buyer. Instead of closing a good deal the firm will end up with a disrupted business, staff who are stressed due to uncertainty and a price the shareholders would normally not have accepted. Management may also have talked themselves into the deal. Management will have taken their eyes off the ball and will have much to do to recover.

How much better would the situation be if the firm had already lined up several possible buyers? They can now announce that they are prepared to sell and take on all offers. Management will have prepared the due diligence files and can execute the deal quickly with little disruption. The staff understand the

process and have incentives to ensure the best deal is done. The exit strategy should be canvassed with staff from an early stage so they understand the objectives of the Investor as a shareholder in the company.

3. The Investor and management decide to sell

Experienced Investors and good management should already know of the best potential buyers and through business operations should already be in a position to actually know those parties. If management have prepared the company for sale over many years, they are best placed to drive the exit process rather than have it drive them. The Investor and management simply need to decide on the timing.

It is a highly desirable characteristic of Angel or VC funding that the Investor exits the investment within a relatively short period. Few Investors like to have their funds tied up for more than five years in a venture. If the prospective investee firm articulates a viable and well-articulated strategy for a trade sale going into the funding negotiations, it will greatly improve their case and the Investor's confidence for achieving the Investor's exit objectives.

With the trade sale exit strategy outlined here, you can be reasonably assured that you will gain the best price you can and know the corporation doing the buying will make more money out of it in the future. If the Investor has a very good idea of the trade sale exit opportunity, he can spend the time assisting management to develop the business and build a strong case for the buyer. This focus makes it easier for the Investor and the entrepreneur to work together since they have clearly defined common objectives.

This process is well proven. If you think of the firms you have seen sold at large premiums, you will always find they created significant value for the buyer.

Preparing for the Investment

Raising VC funds is a process that will involve several parties. The smart entrepreneur wants the best investor, however, the best ones don't go looking for investment, they attract them from known and trusted business colleagues. To find the right Angel or VC investor, the entrepreneur needs to build up a network of knowledgeable contacts within the investment community. The process may well start with a local professional advisor and then extend through more experienced advisors to the ultimate Angel or VC investors.

Professional advisors help to educate the entrepreneur, prepare him or her for the evaluation and the negotiation and ensure that the ultimate deal is fair for both parties. In the end, there is no substitute for quality – both in the professional advice and in the Investor that the entrepreneur ultimately works with.

Only a small number of entrepreneurs will ever raise Angel and Venture Capital finance once and even fewer do it several times. Therefore very few have built up knowledge of the venture capital investment process. Working with professional advisors who participate in these transactions on a regular basis can provide the entrepreneur with insight into how best to prepare for discussions with the Investor. Not only can this save time but it should lead to a better deal for the entrepreneur. The professional services firm should be able to provide introductions to better investors, ensure that the deal is fair and

reasonable and set the right expectations up front so that all parties understand how best to work together for mutual gain.

Accessing the right Angel or VC firm is also an important part of the investment process. Not all Angels or VC firms have the same capabilities, networks and capacity to work effectively with the entrepreneur. Finding the right one can be critical to the ultimate success of the venture.

The professional accounting and advisory firm

The type of advice and help which a professional accounting firm can provide includes assistance in the following areas:

Valuation

The services firm can assist the entrepreneur to prepare a valuation of the business either prior to the investment or at the anticipated exit. If the firm has prepared a valuation of the current business and projected valuation of the business at the proposed exit point, this will contribute considerably to the equity share discussion with the Investor. The advisory firm can assist in the preparation of the valuation or review the financial projections for the entrepreneur, check the completeness and accuracy of the information and review the underlying assumptions and values.

Checking the business plan

The business plan is the foundation document which will be used by the investor to evaluate the investment. It is important that the business plan be prepared thoroughly, be properly explained and contain the information needed by the Investor to undertake due diligence on the opportunity. The advisory firm can review the business plan and show where additional information is needed.

Reviewing financials

Current financials need to be prepared according to generally accepted accounting principles and presented in a conventional format which allows easy analysis. The accountant can ensure that the statements are prepared correctly and the accompanying data fully supports a detailed investigation.

Advice on use of debt and equity structures

The business may be able to support some level of debt as well as an equity investment. Using debt should reduce the equity share which the firm would give to the Investor. The advisors may also be able to show where cash may be better managed in working capital, accounts receivable and accounts payable to reduce financing needs as well as provide independent advice on debt fees and terms.

Helping with introductions and referrals

Well-established advisory firms participate regularly in transactions involving Angels and VC funds. This would include investments, acquisitions, trade sales and IPOs. They are, therefore, in a good position to know local Angels and VC funds on a personal basis and certainly by reputation. The advisory firm can assist with preparing information on the firm for an investment proposal and assist with Angel and VC introductions. An accounting firm can help short list the Investors to approach and can help with introductions or referrals. Since many Angels and VC funds only deal with referred proposals, this can make a big difference in accessing quality Investors. It can also assist in getting an opportunity to the top of the pile as advisory firms act as a pre-reader of opportunities and provide a deal flow which expects a timely response from the better investors.

Reviewing term sheets

While term sheets are typically set out in a conventional format, the Entrepreneur may wish the advisory firm to review the term sheet before it is sent back to the Investor.

Assisting in negotiations

The Entrepreneur who is represented by a well-established and respected advisory firm is likely to be better prepared for the negotiation. At the same time, the Entrepreneur should expect that the Investor will be equally represented by their own advisory firm who would be familiar with private equity transactions. The terms and conditions of the investment should be reviewed by a knowledgeable party so that the Entrepreneur knows that the terms of the investment are reasonable and standard. This should result in more

productive discussions and is likely to be better for the ongoing relationship between the parties. Investors prefer to deal with entrepreneurs who are represented by a professional firm as they know that the entrepreneur will not need to be educated about the investment terms and conditions, the required rate of return, management controls and exit requirements of the Investor.

Due diligence

Due diligence will be carried out by the Investor as part of the initial evaluation of the investment opportunity. This is mostly a product/market evaluation to see if the business environment can support the projections of the firm. After the term sheet is issued, the Investor will carry out an extensive review to further assure he has a thorough understanding of the business and the management and has uncovered any data discrepancies and investment risks. The professional advisory firm can help the Entrepreneur prepare for a due diligence investigation by identifying any problems, risks and deficiencies which need to be addressed.

Advice on pensions, options schemes and remuneration

The professional advisory firm can review these before an investment is made to ensure the current remuneration and benefits are fair and reasonable and provide the most positive basis for the planned exit.

Tax advice

The firm can expect to change significantly over the period of the investment and beyond the exit. Their current tax planning may not be suitable for such changes. The accountant can review the current business processes for compliance, tax collection and reporting.

Exit strategy assistance

A well-articulated and probable exit strategy needs to be prepared as part of the business plan. If this has not already been prepared by the entrepreneur, the advisors can help to define acquisition value, identify potential buyers and/or show how the firm can best position itself for an IPO or a trade sale exit.

Commercial review of agreements

The accounting firm can review legal agreements to ensure they are commercially acceptable. This review should also be done in conjunction with the firm's legal representatives.

The professional legal firm

The type of advice and assistance which a professional legal firm can provide includes the following:

Review share purchase agreement

The share purchase agreement would normally be prepared by the Investor's lawyers. This is a complex legal document which few entrepreneurs will have ever seen and certainly few would understand at any depth. The professional legal firm can review the document, explain the terms and conditions to the entrepreneur and work with the Investor's legal representative to finalise the agreement.

Prepare warranties and indemnities

The firm would normally be expected to provide warranties, representations and indemnities to the investor. The professional legal firm can prepare the warranties and representations and indemnities documents for the Entrepreneur.

Review new employment agreements

The Investor should expect the key executives to enter into employment agreements and will expect to have significant control over their remuneration. Those agreements would normally contain restraint of trade and/or non-compete clauses. The professional legal firm can review these agreements.

Prepare disclosure letter

The firm should be prepared to disclose any issues which may affect the decision of the Investor. It should also identify any potential risks of the business. The professional legal firm can prepare these disclosures and advise the Entrepreneur how to deal with these in the negotiation.

Review corporate documents

As part of the preparation for investment, the professional legal firm will review the corporate documents which authorize the firm to undertake business to ensure that it meets the requirements of the Investor. This review would normally extend to board minutes, shareholder agreements, option schemes and any material contracts the firm has entered into.

The Entrepreneur should plan for 5-10% of the money invested to be spent in professional services fees, noting that smaller deals are likely to have a larger percentage of advisor's fees.

Not all professional services firms have the necessary experience to undertake this type of work effectively. An Entrepreneur seeking their first investment should not assume that their current professional services provider has the expertise to properly advise him in this area. Before starting to incur costs for this service, the Entrepreneur should undertake some due diligence and investigate the extent to which the firm has a track record of success advising Entrepreneurs seeking investment from Angels or VCs. Asking for references would not be unreasonable and they also should be asked for a list of transactions which the firm has participated in and some details of the work performed for the clients involved. The Entrepreneur should also ensure that the expertise is still with the firm and ask to be allocated an advisor with personal experience in these types of transactions.

Selecting an Angel or Venture Capital Fund

Angels and VC firms vary greatly in their capabilities and the extent to which they desire or are able to intervene directly. Some firms prefer a hands-off approach and thus seek a management team able to execute the business plan without intervention. Other VC funds prefer to assist with the selection of some of the management team, stay close to the action and actively participate in setting up deals, promoting the firm and establishing networks.

Most experienced Angels and VC firms are reasonably good at declaring the type of investments they are seeking. They will normally provide an indication of the stage they prefer and the level of investment which they typically

make. These attributes will allow the entrepreneur to prune down the list of Angels and VC funds to those which are active in their target area. Next the entrepreneur can exclude those Investors who target specific industry sectors that are inappropriate. This should leave a smaller list which the entrepreneur can investigate more thoroughly.

The entrepreneur needs to assess what type of assistance (if any) is needed from the Investor. Possible issues might be:

- recruiting senior executives;
- recruiting Directors for the Board;
- accessing industry advisors;
- helping with staff recruitment;
- providing accounting, tax and finance assistance;
- providing legal advice especially in contracts and IP;
- helping with banking relationships;
- providing assistance with closing large customer or distributor deals;
- access to possible acquirers;
- experience with an IPO process; and
- expertise with overseas markets.

The entrepreneur needs to identify how important various characteristics of the Investor are. For example:

- How experienced is the Angel or the VC team? How many firms have they invested in and what is their performance?
- What experience do they have with similar ventures at their stage?
- What experience do they have in their industry?
- What has been their success with prior entrepreneurs? Have they been able to work with them or have they been replaced?
- Have they been able to secure follow on investment?
- What has been their success at trade sales and IPOs?

With larger funds, the day-to-day management of the investee will typically be handled by either an Associate Director or Director of the VC fund. This person or the Angel will most likely sit on the Board of Directors and be involved in the development of strategy. It may be of some importance to the Entrepreneur just how much experience the Angel or the VC fund representative has. A person

with limited business experience may be more of a liability than an asset to the business.

Part of your investigation should be to investigate the Angel or VC fund to see if you would want them as a partner in your business. Aspects that you should look into include:

Reputation

The better Angels and VC funds are well known to the professional services community. Ask for advice from your advisor, lawyer, accountant and banker. Most Angels and VC funds will work with sets of lawyers and accountants on each deal they conclude. The larger professional services firms do the majority of the deals.

Compatibility

You will be working with the Angel or the VC fund and its nominees on your Board for some years. You need to be comfortable with the people you are dealing with and the way in which they prefer to do business.

Investee references

Take the time to talk to the CEOs of the investment portfolio firms. You might also like to talk to those entrepreneurs who have worked with the Investor and have exited. What type of support did they provide to the firms? How did they react to changes in plans, disappointments and missed targets? How did they work with the firm on strategic issues, exit plans, subsequent fund raising rounds, closing deals, providing access to networks etc? Would they recommend them to you?

Generally speaking it is not wise to approach too many Angels or VC funds at the same time. The industry is quite small and most executives in the industry know each other, often work together in consortium funding deals and participate in industry functions. The Entrepreneur who shops around will be identified relatively quickly and probably be dismissed or avoided as the Angels and VC funds may not believe they will get enough time and attention from the entrepreneur to undertake their own initial investigation.

Some Angels and VC funds will only deal with referrals and not look at unsolicited business plans. The VC Fund research data shows that most business plans are only read as far as their executive summary (about 16 seconds on average). Thus having a professional services firm make the introduction provides the Angel and VC funds with some level of comfort that the basics have all been covered. The professional services firm will also provide advice on which Angel or VC fund is best suited for the investment sought.

Many firms with Angel investors will go on to raise Venture Capital finance. The initial due diligence undertaken by the Angel investor and his participation in the business can often provide the level of comfort that the VC fund is looking for. Often angel investors have had prior experience co-investing with a selected VC funds and thus the introductions carry greater weight.

The initial approach to a Angel or VC fund should be with an executive summary. This way the Investor can have a brief review of the investment opportunity without the complication of having to deal with a detailed business plan. If the summary is of interest, it may request a meeting before going into the business plan detail. It will use this meeting to assess the entrepreneurial team as well as the proposed venture.

You may be concerned about confidentiality. Normally this would not be an issue with an established and reputable Angel or VC fund. However, you might like to take some steps to provide yourself with a higher level of comfort. This would include seeking advice from a professional services firm which works actively in the area of private equity finance. Check to see that the Angel or VC fund has no conflict of interest with its other investments, provide confidential data only during later discussions, initially just provide the executive summary and consider using a confidentiality agreement.

Investor Presentation Techniques

There are as many different forms of investor pitches as there are investors. If you are looking for a silver bullet, there isn't one! For every investor who prefers a two minute presentation, there will be as many who want 20 minutes. For every Angel who wants you to tell them how much money you are seeking up front, there will be just as many who would rather have that information at the end when they know what you want to do with the money.

However, don't be despondent. Over 50% of the presentations I hear are seriously lacking and almost all of them have some vital bit of information missing. Rarely have I heard a great pitch. If you can avoid the obvious mistakes, you will be in the minority and if you can provide the essential information, you will be well received. There is nothing wrong with generating questions at the end of a presentation, but what you don't want is your audience to be left wondering why they wasted their time because they don't understand what you do or what you want from them.

Building a story about your business and being able to present it to different audiences is an essential requirement for any entrepreneur. If you are looking for investment, recruiting a key executive, selling to that first customer, borrowing money from a bank or trying to convince a supplier to give you extended credit, you need to be able to give a succinct and compelling explanation of your business. They can't be expected to wade through all the details of your

business to discover if it makes sense. Unless you can provide a short sharp 'pitch' on your business, you are going to miss out on some great opportunities.

The short version of your investor presentation is often referred to as an 'elevator pitch' and is part of the language of venture capital. It derives from an exercise that MBA students were required to do as part of their training in entrepreneurship. You are told you have entered an elevator and next to you is a venture capital executive who will get off the elevator in two minutes. You have two minutes to present a compelling argument as to why he should meet with you so that you can explain your venture in more detail. People who work exhibition stands know the drill very well although they rarely get 2 minutes. If they are lucky they might get 20 seconds.

There is a lot to be learned from building a 2 minute pitch on your venture and trying it out on people who know nothing about your business. The first thing you learn is that 2 minutes goes by real fast. You have to use words sparingly and stick to the most important points. The next thing you find is that your audience does not understand your business at all. They fail to grasp what a great business idea you have, how great the product or service is and how important it is that they invest in it. Basically – they don't get it!! Of course it does not take a rocket scientist to discover that this is not their fault. You have simply failed to structure the explanation in such a way that they could understand it. So go back to the drawing board and start again.

Many people make the mistake of being too technical and providing too much detail, forgetting that the aim of the pitch is to convince the non believer about how financially attractive and robust the business venture is. Generally, the greatest mistake is to fail to provide a clear explanation of the essence of the business; what problem are you solving, how you are solving it and for whom, how big is the opportunity, what is your competition and why you think you can be successful.

For an investor to be seriously interested, they need to see a customer with a compelling need, a product or service that has unique, hard to copy attributes which fulfill that need and enough potential customers to make it a reasonable size business. You have to convince them that you have the team that can execute on the opportunity. Lastly, it has to provide a good return on their

investment through a public listing or by selling the business within a relatively short period of time, say, 3 – 5 years. You need to be able to deliver that message in two minutes. A longer presentation allows you more time to present greater detail but the core message is the same.

At one investment pitch session for angel investors which I attended, eight seed and early stage ventures were given 20 minutes to present their investment opportunity. The presentations varied from poor to very good and from boring to passionate. However, most of them failed to clearly define the problem they were solving and why their solution was better than the competition. Some forgot to provide statistics on market size, what portion they could capture within a reasonable period of time and how they were going to do that. Not one of them had a clear explanation of the exit strategy, perhaps the most fundamental aspect of any angel investment.

I suspect that with further probing, all of these ventures could have been made to look attractive. Angel and VC investors are not typically passive investors who put their money in and wait for the cheques to come; they are active investors who typically assist the venture to develop. They do not expect the business model to be ideal at the initial investment stage, but they do expect to be given enough information to decide whether to spend more time in the investigation of the opportunity. Most of these ventures wasted their presentation time at this forum as they were poorly prepared, had failed to test out their presentations with non expert audiences and lacked practice. Following each presentation, the angel investors were given an opportunity to ask questions and the teams were able to see where they had failed to present essential information. Fortunately for them, they also received some very good advice on areas where their business strategies could be improved.

Whether you have 20 seconds, two minutes or an hour to present your business opportunity, you do need to prepare and practice the presentation otherwise you are wasting invaluable opportunities. As a potential recruit, a prospective customer or investor, I want to be convinced by both your passion and your argument. If you can't explain succinctly what you do and why I should be a part of your grand venture, why should I waste my time working with you?

What Investors Want to Know

Put yourself in the investor's shoes. Why are they there and what do they need to know to have an active interest in talking to you further? Remember, they hear lots of presentations, don't really care about the product or service and are really interested in the risks and rewards for their investment. Keep in mind that without a highly probable exit event, they don't get their money back and don't achieve a return on their investment, so don't forget about the exit.

While there is no 'one size fits all' presentation, the basics should include the following:

Introductions

Who are you, what is your position in the business and what is the name of the business.

What does the firm do?

You should be able to state what your business does in a few sentences.

"We provide security safety fences for high rise building developments"

" We develop skin care products designed for tropical climates"

What problem or need are you addressing?

You would be surprised at how often I ask 'What problem are you solving?' at the end of a product presentation. I hear all about the features and functions, how it beats the competition and that customers love it, but half the time I am not told what problem or need it addresses. The key here is to explain why customers need the product. What pain are you addressing? What need are you satisfying? Why can't the customers defer, delay or avoid buying it? What evidence do you have that your solution is effective and that customers will buy it at the price you propose?

Who is the customer?

I want to know exactly who the customer is and why they need it. How

do you put yourself in front of your target customer with a compelling proposition?

What is your competitive advantage?

A strong competitive advantage means that you solve the problem better than anyone else and that customers with that need or problem prefer your solution. You also need to demonstrate that you can protect your advantage over time through some registered IP (patent, brand, copyright, license, trademark etc) or a level of deep expertise which is difficult to copy, mitigate, develop or acquire.

How big is the market?

This is where evidence is required about the number of potential buyers, the manner of distribution and the conversion rate of prospects to sales.

“In our initial pre-release testing we had a take-up rate of 9 in 10 tradesman. With 600,000 tradesman in our target region, we can expect sales of \$2 million within 2 years of the initial marketing campaign. Replacement sales are anticipated to be at a rate of 20% per annum.”

What is your distribution strategy?

How are you going to distribute the product and put your product or service in front of your target customer? There are a variety of strategies which can be used; direct sales, internet, retail, wholesale and manufacturing license. Which ones will you be using and why do you think they will be effective in meeting your revenue and profit targets?

What is your exit strategy?

Unless you have an exceptional high growth venture which could achieve an IPO, your business will need to be sold in a trade sale to achieve an exit. What is your target exit date? Which companies have you identified who would be interested? Why would they buy your business and what is the estimated sale price?

What do you need to do to achieve the exit?

What are the milestones you need to achieve and tasks you need to complete to succeed in a trade sale or IPO event? This might include product development, proof of concept, revenue targets, strategic relationships and so on. If the exit is a trade sale, you should have selected the potential buyers, have a plan to approach them and understand why they would want to acquire your firm.

Who is going to do the work?

Who is on the management team? What are their qualifications and experience and which positions need to be filled for you to deliver on your strategy? Why do you think this team is capable of achieving the milestones and exit outcome? It is OK to have an incomplete management team but you should show how you plan to fill those vacant positions.

How much investment do you need?

How much funding do you need, when do you need it and what is the money going to be used for?

What are you offering the investor?

While this will certainly be negotiated, if you can, you should give some idea of the level of equity participation and the likely return to the investor.

Be prepared! You may expect to have 20 minutes to present and then be told you have only 5 minutes. You may anticipate doing a formal presentation to be told that they only want a short description of the investment proposal.

The Elevator Pitch

Sometimes you only have a minute or so to get the message across. In those situations you need to focus on the essentials and ensure your audience understands what you do and why they should come and talk to you after your presentation.

Here are two examples from ventures which I have been involved with. Each of these presentations could be done in less than one minute.

Investor Pitch for Pioneer Computer Group (1990)

My name is Dr. Tom McKaskill and I am the President of Pioneer Computer Group, a software development business located in Northampton, UK, with offices in London, San Diego and Auckland. The business develops, markets, implements and supports integrated enterprise wide resource planning (ERP) applications for both discrete and process manufacturers and a set of software development tools (4GL). The business currently employs 160 staff and has revenue of \$15 million.

PCG has over 200 customers for its ERP systems and over 2,000 customers for its 4GL products spread across 16 countries supported by its own staff and over 20 distributors. PCG has partly completed the world's first 4GL, relational database ERP system for process manufacturing which has received significant interest from early customers, distributors and our major strategic partner, Digital Equipment Corporation. The process manufacturing ERP market is anticipated to be the next big growth market in the software applications space. PCG have just signed an agreement to install the system in 16 factories of a large UK based manufacturer, the largest manufacturing software contract signed this year in Europe.

PCG is seeking \$2 million to complete the development of the process manufacturing suite, set up trial sites in the USA and seek a strategic US buyer for the business. We estimate sales of the new product to exceed \$100 million in the first two years of release in the USA giving a potential trade sale exit value of around \$50 million within 2 years.

This explanation would be improved if I had identified the potential buyers and the reason why they would be willing to pay a premium to buy the business, but you can see how much information can be delivered in a brief statement.

Investor Pitch for Distinction Software (1997)

My name is Tom McKaskill and I am President of Distinction Software, a software development company which provides an integrated suite of software modules for supply chain optimization for medium sized process manufacturing companies who manufacture high volume, low priced consumer packaged goods.

Our product suite optimizes the relationship between retail demand, warehouse inventory, logistics, manufacturing capacity and raw material inventory. The package uses a sample of client data and shows a payback time on the cost of the software of less than 6 months.

The product suite is one of only a limited number of fully completed and implemented supply chain optimization products worldwide.

The market for such products is growing rapidly and there is keen interest from large application software providers to enter this market. These products are highly specialized, take years to develop and are expensive to complete.

Our exit strategy is to sell the business to a global software corporation providing them with an immediate revenue opportunity within their existing customer base as well as a strong competitive advantage for future sales. We estimate an exit price of around \$60 million.

We are seeking \$2 million to complete multi-lingual translation, multi-country trial implementations and documentation and training material required for a global release.

This description was my first attempt. Note that I do not mention revenue, staff numbers or projections. With any presentation, you should improve each time you do it. It is important to be able to explain your business in one minute or in a description which is no longer than one page.

Powerpoint Presentation Guidelines

There are lots of ways of doing a presentation and therefore there is not one format which is perfect but the basic rules of presentation still apply.

Do's of Presenting

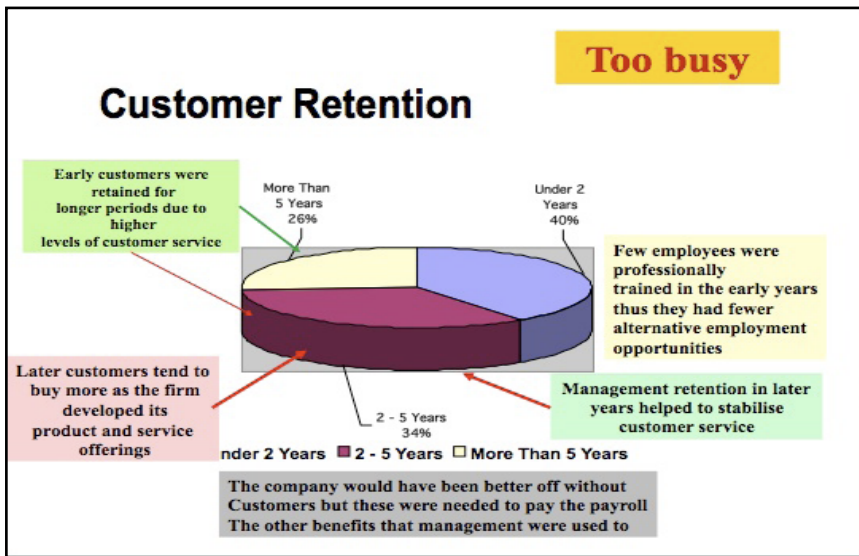
- Outline why you are there
- Tell them what you are going to tell them, tell them and then tell them what you told them
- Have a logical flow, be confident, positive, focused and professional
- Use photos, diagrams and videos to demonstrate your product
- Show you know what you are talking about
- Be honest (identify problems, risks, outstanding work)
- Tailor your presentation to the target audience (why are they there)
- Be realistic and reference your data sources
- Limit the number of points to a slide
- Use at least an 18pt font. Major bullet points should be at least 24pt

Don'ts of Presenting

- Don't make ambiguous, vague or unsubstantiated statements
- Don't use technical or industry jargon
- Keep the sizzle down - stick to the meat
- Keep the slides simple and to the point
- Don't be casual, uninterested or otherwise engaged - show you are keenly interested in the decision
- Don't read and don't present financials to 3 decimal places.

Powerpoint is a very powerful tool but can be over-used. The slides are there to allow you to convey information - remember that your audience can read so you don't need to read them out. The order of slides allows you to control the flow and pace of the presentation. You are telling a story, make it interesting but stick to the central theme.

Your audience should be able to read everything on the slide within a few seconds. Don't put so much information on the slide that it distracts them from listening to your explanation.



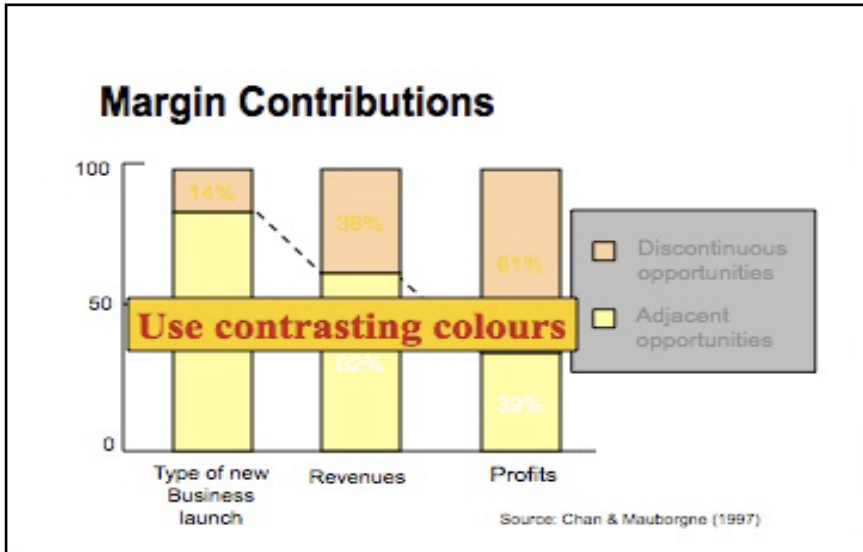
Use fonts you can read from a distance. Avoid TLCs and technical jargon if you are presenting to a non-technical audience.

The Firm

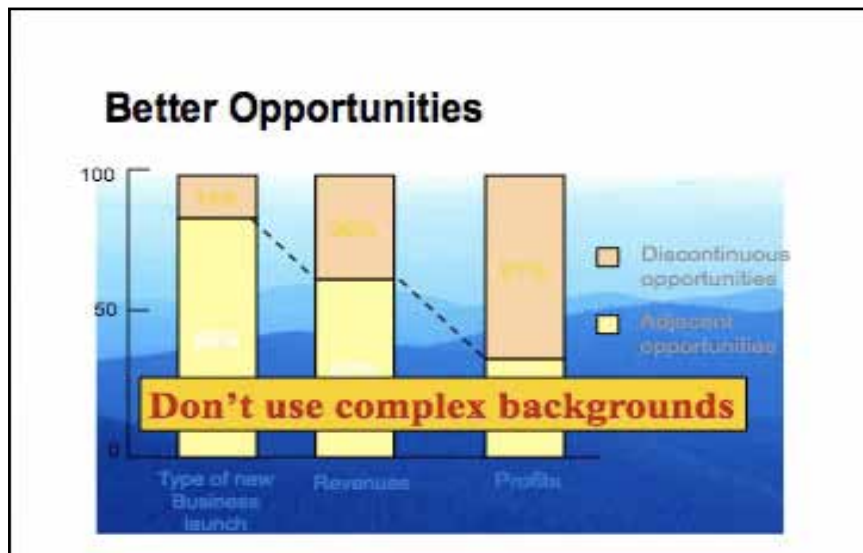
- is an integrator. Its services bring together diverse technologies, multiple manufacturers and the customer needs to produce an appropriate solution for the customer.
- SCCS is computer infrastructure builder. It supplies PCs, notebooks and network servers and supports everything it installs. SCCS provides maintenance and repairs. SCCS people can support customers' IT staff or simply be the customers' IT staff. SCCS installs operating systems and virus protection. SCCS builds Internet infrastructures, installs firewalls and consults in all aspects of networking. SCCS is known as an integrator because the hardware and software components of the networks which it builds come from diverse manufacturers and it is the SCCS effort and expertise which turns these components into working networks.
- Long term customer relationships

Font too small, too complex

Ensure the colours you use are easy to read. Put contrasting colours together so the text can be read easily.



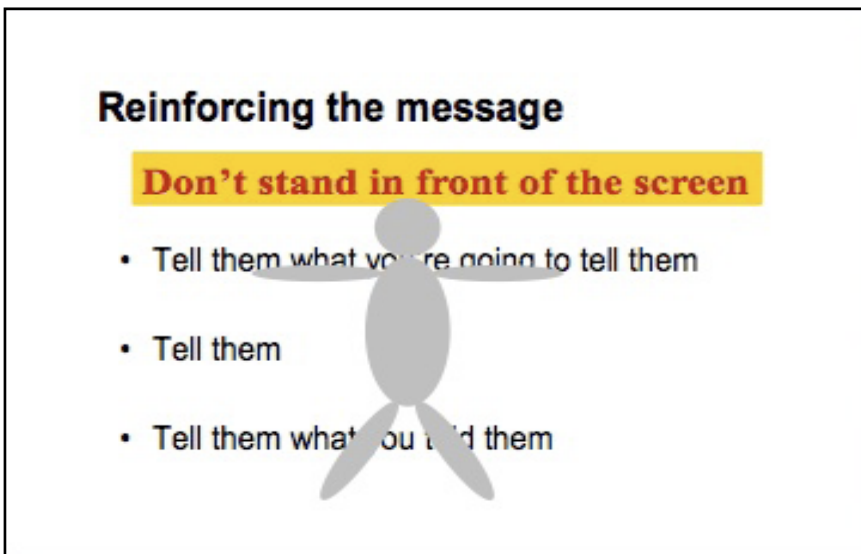
Avoid using backgrounds which have lots of different colours or shades. It is very difficult to get contrasting colours when you have complex backgrounds.



You are presenting to a professional audience so avoid the gimmicks. Don't use fun graphics, noises or fancy animations.



Your audience wants to read what is on the slide.



Why Are You There?

Be very clear in your own mind what you want to achieve from your presentation and ensure you come back to that at the end. Listen carefully to the questions and make sure you answer them rather than simply repeat what was in your presentation.

Learn from every presentation:

- What went right, what went wrong?
- What questions came up later - can this information be incorporated in the presentation?
- Find out where the weak points were.
- Where were you not convincing?
- In the story, strategy, concept - what did you miss?
- Who or what do we need to do to be successful?

Your presentation is only the first step, you need to have a plan to follow up on the meeting. Ask for business cards of those who would like a further discussion. You can also ask if you can send them additional information.

Presentation Checklist

After you have put your presentation together, check it against the following list. Depending on the type of business and the type of exit, not all of these items will be relevant and some will need more detail than others.

Almost without exception, you will have made some assumptions about your audience, especially their knowledge of your industry and technology. You need to deskill your presentation for a general audience. The best way to do this is to give the presentation to people from outside your sector. Try it on friends, siblings, your spouse/partner/mother and your co-workers. If there is something they don't understand or have difficulty following, you need to change your presentation. At the end of the presentation, you might ask them questions about your business and investment opportunity and see if they understood it. These days it is not essential to wear a business suit and tie but neat and professional is important.

- Introduce yourself and your other presenters
- Who are you and what do you do?
- What problem or need do you satisfy?
- Is the customer clearly identified?
- Are you showing why the customer should buy from you?
- Are you identifying your principal competitors?
- Are you identifying your sustainable competitive advantage?
- Are you showing who the management team is?
- Do you have financial projections with worst, likely and best case?
- Are you identifying the risks in the deal?
- What problems are unresolved or needed additional work?
- Do you have a well defined exit strategy?
- Have you identified what needs to be done to deliver on the exit event?
- Have you said why you are there and make the investment request?
- Is the investment opportunity well defined and convincing?
- Are your Powerpoints clear and easy to read?

Depending on whether you are a financial or a strategic exit, your explanation of what is important can be very different. With a strategic trade sale, the key is to identify the strategic buyers and explain why they would want to undertake the acquisition. In a financial sale or an IPO, you need to show that you can create a high growth venture.

The last time I raised venture capital I did over 30 presentations to venture capital firms in 5 cities up and down the eastern seaboard of the USA. Each time I learnt a little more about what they were interested in and refined the presentation. What I also found was that even the best opportunity had to fit into their investment criteria, investment portfolio, sector preferences and level of investment. You may need to do a number of presentations to different audiences before you find a match.

Some organisations will have a preferred presentation outline which they would like you to follow. Ask them if they have a specific format which they prefer. Often they will want an executive summary either in advance or on the day. This needs to cover the major points of the investment proposal and should include contact details for those who wish to explore your proposal further.

Some organizations like to have a written business plan available for those who wish to examine the proposal further.

With formal Powerpoint presentations, many organisations like to hand out a copy of the slides to the audience so they can make notes during and after the presentation. Remember to invite the audience to ask questions and offer your business card for follow-up discussions.

Most investors try to put themselves into the shoes of the target customer and ask the question “Why would I buy this product and from this firm?” They try to do this as early into the presentation as possible so they can understand the business. This means that it is really important to deal with this issue as early into the presentation as possible. Showing the product, demonstrating it or showing a short video or photo of it in use can be quite effective.

I have sat through many presentations where I didn’t understand what the product was or what problem it solved until well into the presentation. The problem for the presenter was that most of the audience were not listening to the content because they were still focused on working out what the business did. You should not be spending more than a minute or so on describing your product or service. Once the audience understands what you do, move on to the core of the presentation which is about what you need to do to develop the business, the investment required and the return which the investors will receive by participating in the venture. If you are at the idea stage or still developing your business concept, simply state that in your presentation, but ensure that your host understands that prior to the presentation and has the opportunity of setting the right expectation for those who will be attending.

If you are not sure what level of detail is required in the presentation or are unfamiliar with some of the terms used by investors, ask your host. You can also learn a lot about Angel and Venture Capital funding from articles, websites and books. The more familiar you are with the requirements, the better prepared you will be to deliver your presentation and answer the questions.

Valuation

Once the investor has evaluated the investment proposal, the discussion will usually move to the question of valuation. Entrepreneurs have always seen the initial valuation as the most important part of the investment process – as this can impact greatly on what they walk away with on exit. At the same time Investors see entry valuation as the key to the investment return – if they get too little equity they may not get a reasonable return on the exit if the venture is not overly successful. Thus valuation discussions can be stressful on both parties and often somewhat emotional. Finding a path through this discussion is critical if both parties are to proceed with the investment and still retain a positive working relationship.

Traditionally Investors and entrepreneurs have used the existing revenue and profit or near term revenue and profit as the basis of a valuation discussion. While the exit is always a consideration, few use this to arrive at a current valuation. Typically, exit planning is deferred until the investor has made the investment and had some experience with the venture when the investor has a better idea of the market and the venture capabilities. But in fact, this is the critical event and should play a much greater part in the investment decision and the valuation discussion.

Valuation

Valuation of an existing business before VC and Angel funding and valuation of a business following funding has to be the most controversial topic in the venture capital literature. It is the greatest source of conflict between entrepreneurs and Investors, is plagued by emotion, misunderstanding, entrenched position taking and ignorance. It has often been said that 40% of deals fail to secure funding due to a failure to agree a valuation. What is regrettable is that it is highly possible that many of these ventures could have made both the Investor and the entrepreneur considerable wealth.

Valuation is the process of estimating the monetary amount the firm is worth based on its future expected returns. Valuation is a function of risk and return and considers:

- the expected return from an investment in the firm
- the expected returns from investments in other comparable firms
- the risks associated with the expected return
- any other relevant characteristics of the firm or the industry/ geography in which it operates.

A more conventional definition of market value is: the price that would be negotiated between a knowledgeable and willing but not anxious buyer and a knowledgeable and willing but not anxious seller acting at arm's length within a reasonable time frame.

While this is probably not true of Angels, entrepreneurs often refer to venture capitalists as greedy, one-sided, 'vulture capitalists'. On the other hand, venture capitalists and Angels complain of entrepreneurs being unrealistic, unwilling to negotiate a fair value and ignorant of the balance between risk and return.

Valuation models

In the absence of an independent offer to buy the firm, the valuation of a private firm is a highly judgemental process. Valuation models are each designed with different purposes in mind. Like the problem of identifying cost, (historical cost, replacement cost, market price, incremental cost, inflation adjusted cost, depreciated cost) it depends what you want to use it for.

The major valuation models are:

- Earnings-based
 - Capitalisation of future maintainable earnings
 - Discounted future cash flows (DCF).
- Asset-based
 - Going concern value
 - Realisation value
- Industry-specific based
 - Market value
 - Rules of thumb.

In emerging businesses seeking venture finance, only the earnings based valuation models are relevant. Traditional earnings based valuation methods have been established to value existing business where historical data can be used to show revenue and profit trends and where established products have a market presence. However, most emerging ventures which seek funding are of limited life, have little history and a somewhat speculative future. Thus while traditional methods of valuation don't really apply, the entrepreneur should be familiar with their use as valuation discussions may involve them. In order to start any sort of meaningful discussion, the conventional approach to valuation for an investment has been to write a forward projecting business plan and then to try to use this as the basis for discussion.

Most Investors will estimate a future (exit) valuation based on a four to six times earnings before interest and tax (EBIT) multiple of the projected profit at the time of harvest of the investment and then work backwards using an internal rate of return (IRR) to reflect the risk in the venture to arrive at a post funding valuation. Early stage ventures may attract a 55% IRR with more advanced ventures attracting 20% to 40% depending on the expected risk. However, even this valuation is highly speculative as more funding rounds may occur, each setting a new valuation at the time of funding. To arrive at the equity percentage for the Investor, the investment required is deducted from the post-funding valuation and then the 'pre-money' valuation is arrived at. The Investor's equity percentage can then be calculated from the ratio of investment to post-money valuation.

Strategic trade sales require a different approach as the valuation is based on the expected earnings of the buyer in the first few years following the sale. However, a valuation can be applied to this stream of earnings to arrive at an exit value.

Capitalisation of future maintainable earnings

Capitalisation of future maintainable earnings methodologies include:

- Price earnings ratio (PER)
- Pre-tax earnings multiples such as earnings before interest, tax, depreciation and amortisation (EBITDA), earnings before interest, tax and amortisation (EBITA) and earnings before interest and tax (EBIT).

Earnings-based valuations are used as a proxy for the Discounted Cash Flow (DCF) methodology.

The PER can be applied in two ways:

- Total value of the firm: PE multiple x net profit after tax (NPAT)
- Value per share: PE multiple x earnings per share (EPS)

The PER is applied to an estimate of earnings after tax. The value derived using a PER is a valuation of the ordinary shareholders' interest. This is described as an equity value.

Valuations based on EBITDA, EBITA or EBIT multiples calculate the Enterprise Value of the firm before factoring in the way it is funded. The Enterprise Value is typically adjusted for the following items to calculate an Equity Value:

- Interest-bearing debt
- Surplus assets
- Contingent liabilities
- Future capital expenditure

To further explain the difference between Enterprise Value and Equity Value consider the following example of somebody's house:

Item	\$	Value
Market Value	500,000	Enterprise value
Bank Debt	400,000	
	100,000	Equity value

Some sectors have well established valuation norms. These can vary with the economic cycles reflecting likely growth or depression trends. Multiples applied to mature industries with little likelihood of growth are generally lower than multiples applied to growth sectors. Firms which have experienced higher than average historical growth will usually command a higher multiple on the basis that future growth is also expected to continue at higher than average rates i.e. history is often used as a prediction of the future.

The assumption underlying the PER method is that the firm has stable or predictable earnings, that these will continue on a linear path for some years, the business will not change from its current business model and there is an appropriate debt/equity mix.

It is useful to set valuation expectations prior to going into a valuation negotiation. If the sector is currently valuing listed corporations at 10 times EBIT and the firm is seeking something higher, they have unrealistic expectations. If on the other hand they are seeking five times EBIT, you probably have a basis for negotiation.

The earnings used in a valuation need not be the actual historical earnings. Earnings should be adjusted for abnormal, extraordinary and non-recurring items to determine a normal level of earnings. If the entrepreneur can show highly probable growth with achievable revenue and profit targets, future earnings might be used to calculate a market valuation. However, it is important to avoid double counting growth by using future earnings and applying a 'growth multiple'.

Discounted cash flow (DCF)

A DCF has two elements:

- forecast of future cash flows of the firm for a number of years into the future
- discounting the forecast cash flows back to a net present value (NPV) using a discount rate which reflects the riskiness of those cash flows.
- The preparation of a DCF can be challenging as it can be difficult to:
 - accurately forecast cash flows for a number of years into the future
 - select an appropriate discount rate.

The discount rate should represent the risks associated with generating the expected earnings of the firm. In many cases entrepreneurs and Investors will simply use the Investor's investment hurdle rate.

This method is somewhat more problematic. It is based on discounting future free cash flow to a present value. The free cash flow, or uncommitted cash surplus, represents the cash available to pay off the initial investment plus provide a return on that investment.

Most high growth businesses invest heavily in growth capacity. This might be R&D, sales force, promotion, channel expansion and so on. Few entrepreneurial ventures have spare cash.

The DCF discount rate in an Angel valuation is likely to be 35-40% and a VC fund 25% -35%.

When deciding on a valuation for a strategic exit, a value is arrived at for the exit price and then discounted to a NPV.

Fundraising alternatives

It is useful to put Angel and VC investment into context.

Let's say the entrepreneur wanted to borrow \$1 million. His choices are a first or second mortgage on his personal home, a loan secured on business property, a loan secured on inventory, or a loan secured against debtors.

Secured loans can normally be recovered by the lender as a market exists for the pledged asset. The lower the likelihood of recovery, the higher the interest rate and the lower the percentage advanced on the value.

Borrowing against the entrepreneur's home would possibly result in a professional valuation, which may be lower than the entrepreneur would willingly agree and a loan of probably not more than 80% of the valuation.

A bank is likely to seek higher rates of interest on a second mortgage to compensate them for the additional risk of the second mortgage. If scheduled repayments can't be met, the bank has the right to sell the home and recover their debt plus accumulated interest and costs.

Securing a loan on business property may be a little more expensive as business properties generally experience more fluctuations in value. A premium above a second mortgage on a house is likely.

Taking a loan on inventory is of much higher risk as the inventory may suffer from obsolescence or damage. Usually the recovery can only be made at an auction which itself often returns much lower values than in the normal course of business. So an advance of not more than 50% of book value may be made but with an interest rate higher than the above mentioned rates. A similar treatment may be applied to debtors except that it may be limited to 50% of approved debtors, perhaps only those aged 30 days or under.

Now let's consider the typical early stage entrepreneurial business, which will display some or all of the following attributes:

- uncertain cash flows
- few tangible assets
- some specialised equipment which typically becomes technically obsolete
- few debtors
- little inventory
- new and sometimes unproven products or services
- often an immature management team
- an emerging market which is yet to be stabilised

- no established market for shares, especially a minority holding
- uncertain timing of revenue and profitability.

So, unlike a secured investor such as a bank, the Investor has an illiquid market in which to sell the shares, is dealing with high levels of uncertainty in the business and the market and the management team has no security for the investment.

If a risk free rate in Government Bonds is yielding, say, 6% over a long term, what return should an Angel or VC investment under these riskier conditions return over a portfolio of such investments? The typical Angel or VC investor will invest across a range of ventures expecting to return, on average, approximately 5% above long-term share market returns. However, within this portfolio some investments can be expected to be written off, some may break even, some may make a reasonable return and one may make a sizable return. In order to achieve a 15-20% average pre-tax return, the Investor needs to set a pre tax hurdle rate of at least 25-30%. Investors with a technology, biotechnology or early stage investment focus tend to seek higher returns (potentially in the order of 35-40%) due to higher failure rates. Only a small percentage of the exits will exceed 7 to 10 times their investment, thus the Investor may set a relatively high hurdle rate knowing that those investments which fail or have poor returns will pull down the average.

Most entrepreneurs will accept this logic. So where is the problem? The problem is in the often extreme views of the likely outcome. Entrepreneurs by their very nature are optimistic. Investors, while not being pessimistic, are cautious and have been conditioned by failed ventures, all of which started out looking very positive. In truth, it is the pursuit of the target value which often causes the venture to fail. If the Investor has to achieve a high value to exit their investment with a good return, the pressure is on the entrepreneur to push the growth rate. It is often this pressure which creates the conditions for insolvency and failure.

At the same time, the gold medal for an Angel or VC investment is an IPO, not withstanding that the most common exit mechanism is a trade sale. This means ever growing revenue and profit targets. However, the successive yearly targets are inherently risky. The growth rate puts huge pressure on the organisation and the cash needed to fuel the investment in inventory, debtors, recruitment,

training, accommodation, research and development, development of distribution channels, customer support and so on. Much of the investment is in growth preparation rather than in servicing the current customers.

Let's consider an example:

The business is achieving \$5 million in sales with 20 staff. It is currently making 5% net profit after tax (\$250,000). The business is valued at six times net profit after tax, therefore the pre-investment valuation is \$1.5 million. The firm raises \$1.5 million for 50% share giving it a post-investment valuation of \$3 million. The Investor expects to achieve an ROI of 25% with a planned exit in four years. Assume that revenue grows at 40% per annum and the revenue per head remains constant.

Year	Revenue '000	NPAT '000	Employees	Valuation \$ million	Investor share \$ million
1(a)	5,000	250	20	1.50	0.00
1(b)	5,000	250	20	3.00	1.50
2	7,000	350	28	2.10	1.05
3	9,800	490	39	2.94	1.47
4	13,720	686	55	4.12	2.06
5	19,208	960	77	5.76	2.88

Notes:

- (a) Pre-investment valuation
- (b) Post-investment valuation which includes \$1.5 million of surplus cash
- The Investor's additional capital of \$1.5 million is used on capital expenditure to increase business capacity.
- Years 2-5 assume \$nil surplus cash and \$nil debt
- Assumes 5% net profit after tax in all years
- The Return on Investment is 17% which does not achieve the 25% target expected by the Investor.

Imagine all the things which can go wrong over that five-year period: the market may change with new competitors, the market size may be considerably less than estimated, new technology may make the product obsolete, the firm

may be unable to recruit quality staff at the rate needed and so on.

While size is not the only determinant of a company's ability to undertake an IPO, in the above example the growth rate would most likely be insufficient to create an IPO opportunity and therefore the Investor would need to pursue a trade sale as an exit mechanism. For the same firm to gain the level of sales and profitability to achieve an IPO, they would have to grow at a significantly higher rate.

The business risks associated with high growth rates are significant and require a massive change in organisation structure, processes, systems and formalised controls.

The executives who are capable of running a 20-person firm are probably unsuited to a 200-person firm. Very few entrepreneurs have the skills to make this transition.

The Investor who pushes an investee firm to an IPO may create the seeds of their own failure. Regardless of the product/market opportunity, very few management teams are capable of managing a high level of growth. Growing firms tend to require significant levels of working capital and investment into the business. Consequently, cash reserves are generally stretched and even a small mistake can result in rapid dilution of cash reserves sending the firm to the brink of insolvency. As Investors require an exit, in these circumstances some Investors may panic, replace management and probably push the firm into a fire sale to recover as much of their investment as possible.

The initial valuation may create the platform for future failure. The higher the initial valuation, the greater the pressure to grow and the higher the likelihood of failure.

To protect the investment from some of the risks mentioned above, the Investor is likely to push the initial valuation down so that they have a greater chance of gaining a final exit which will return the ROI needed. They also build in conditions which allow them to replace management if the team fails to achieve the milestones needed to keep them on track to reach the target exit valuation.

A lower valuation has the benefit of taking some of the pressure off the entrepreneur. Reaching a target ROI for the Angel or VC investment is more likely, the intermediate milestones are likely to be more easily reached and there is not undue pressure on growth. The downside is that the entrepreneur will give up more equity at the lower valuation.

Which valuation should you use?

Too many entrepreneurs produce five year forecasts based on assumptions which are, at best, educated guesses as to the state of the economy, the reaction of competitors and the behaviour of prospects. They then use complex formulae to work out a Net Profit After Tax (NPAT) over five years. From this profit forecast they calculate a valuation to four decimal places using an assumed discount rate. At the very best, it is one person's view of the future, but it fails to recognise that any other view might be equally valid.

In truth, no-one can accurately predict the future. The entrepreneur is generally going to be optimistic and the Investor somewhat pessimistic. Somehow they have to come to an agreement on a valuation or the negotiation simply never goes anywhere.

Entrepreneurs should be highly averse to high valuations. While they look good at the start of the venture, they place unrealistic expectations on the business to perform. Even the slightest slippage can lose the entrepreneur his business. Investors are not known to take shortfalls kindly. The problem is that they have their own investment to protect. Far better for both parties to agree a lower/negotiated valuation where the Investor can readily make his hurdle rate and the entrepreneur has a better chance of staying in control and making a reasonable return on his effort.

Negotiated valuation

One method of arriving at a valuation is to consider what the valuation of the business may be at a future exit date and discounting this value back into today's dollars. This method also has more relevant application to strategic sales. The future exit valuation of the firm is highly speculative and is a metric of real interest to both parties. If it was known with some certainty, the current valuation could be more readily determined by using a discounted cash flow

methodology. The discount rate could be adjusted for higher levels of uncertainty but it would still be a place to start.

So, for example, a firm with an exit valuation of \$10 million in three years with a discount rate of 40% would be worth \$3.64 million now. A \$1 million investment would thus gain the Investor 27.5% shareholding.

Possible alternative valuation scenarios to the above are:

- The Investor wanted some higher comfort factor. A higher rate of discount may be used, say 50%, which would result in a lower Net Present Value (NPV) of \$3 million giving the Investor 33% equity.
- The Investor wanted some higher comfort factor. A lower exit valuation may be used, say \$8 million, which would provide a NPV of \$2.9 million, giving the Investor a share of 34.5%.
- The entrepreneur is more optimistic than the Investor and believes that an exit valuation of \$20 million is likely. This would give a NPV of \$7.3 million and the Investor share of this would be 13.7%.

The real problem lies in the balance of risk and reward. If in fact a low exit value was achieved, both parties lose but the Investor is likely to be the one with the highest cash investment loss. The entrepreneur and his team will have put time and sweat in but probably much less cash.

At the same time, if a high value is achieved, both parties would seek the upside. The entrepreneur would most likely claim that he deserves the most credit because it is his vision, business model and leadership that are probably the key to success, not the cash from the Investor. The Investor would most likely argue that the business could not have achieved the high valuation without the cash injection from the Investor. The Investor of course wants the lower valuation in case things go wrong and so the upside is much higher. The entrepreneur wants a higher valuation to limit the equity of the Investor if the venture proves very successful.

A solution for both parties lies in negotiating a valuation formula which both parties can live with. This could be a stated value at somewhere between the Investor valuation and the entrepreneur's valuation, or it could be a starting value but with equity adjusted up or down for different levels of success.

So, for example, the parties could agree a strike point which would determine initial shareholding. This could then be adjusted for higher or lower exit valuations. For example, the parties could take the two opposing valuations and use these as a basis for calculating the shareholding at exit.

Negotiated valuation – Example 1

- Investment is \$3 million for an initial 33% equity share.
- Exit after three years.
- The Investor estimates a \$25 million exit.
- The entrepreneur estimates \$50 million.

In this example the parties have agreed on the following:

- Investor's equity share will remain at 33% for all exit valuations below their expected valuation of \$25 million.
- The Investor's ROI on exit valuations between \$25 million and \$50 million are held at 40% thus giving the Investor certainty of returns.
- Where the entrepreneur's estimate of \$50 million is achieved, he retains a greater proportion of the equity (i.e. the Investor's share is reduced to 16.4%), but the return the Investor earns is significantly greater than at lower valuations.
- Consequently in this example both the entrepreneur and the Investor share in the upside of higher valuations.

Exit valuation \$ million	Investor portion \$ million	ROI to Investor % per year	Strike valuation	Investor's equity share %
5	1.64	Negative		33.0
10	3.33	4		33.0
15	5.00	19		33.0
25	8.25	40	Investor exit estimate	33.0
30	8.20	40		27.3
40	8.20	40		20.5
50	8.20	40	Entrepreneur's exit estimate	16.4
80	13.10	63		16.4
100	16.40	76		16.4

Negotiated valuation – Example 2

Alternatively, a much more aggressive model would see the valuations move in the Angel's favour with lower exit valuations and more security on the downside for the Angel. This acknowledges the need for the Angel to achieve their desired ROI. At higher exit valuations, the pendulum swings the other way, increasing the reward to the entrepreneur for outstanding performance.

In this example:

- Angel investment \$3 million.
- Exit after three years.
- The Angel estimates a \$25 million exit.
- The entrepreneur estimates \$50 million.

In the example set out below, the parties have agreed the following:

- Angel's equity share increases at low valuations thus providing more security on the downside.
- The entrepreneur retains a greater share of equity at higher valuations while still allowing the Angel to earn a significant rate of return.

Exit valuation \$ million	Investor portion \$ million	ROI to Investor % per year	Strike valuation	Investor's equity share %
5	5.0	Negative		100.0
10	8.2	19		82.0
15	8.2	40		55.0
25	8.2	40	Investor exit estimate	33.0
30	8.2	40		27.3
40	8.2	40		20.5
50	8.2	40	Entrepreneur's exit estimate	16.4
80	9.3	46		11.6
100	10.0	50		10.0

Negotiated valuation – Example 3

For a smaller deal the model might look like this:

Investment \$3 million and an Exit after three years.

Exit valuation \$ million	investor portion \$ million	ROI to Investor %	Strike valuation	Investor's equity share %
1	1.0	Negative		100
3	3.0	Negative		100
8	8.0	38.7		100
10	8.2	40.0	Strike valuation	82
15	9.0	44.0		60
20	10.0	49.0		50
30	12.0	59.0		40
50	15.0	71.0		30
100	17.0	78.0		17

This type of formula can be used over successive rounds of Angel or VC funding. Each round would put in place the formula for determining the share of the final exit valuation to the new investor.

The entrepreneur who is unwilling or unable to accept a lower/negotiated valuation, should consider seriously a ratchet where the entrepreneur earns additional equity for achieving certain pre-agreed milestones/targets. These targets could be qualitative or quantitative in nature.

Investors want to ensure that, at the very least, they don't lose any money on the deal. An investor is much more sensitive to a loss than to a significant gain. There is considerable pressure on the Investor to push down the valuation. However, a lower valuation means the entrepreneur makes much less when they exit the business and therefore the Investor needs to find a valuation figure which strongly motivates the entrepreneur.

Angels and VC investors can use a variety of techniques to achieve this balance. One simple technique is to set the return to the Investor at a specified rate of return. Any excess over this amount from the exit proceeds goes to the entrepreneurial team. Another technique is to establish the investment as preference shares with an accumulating dividend. Since preference shares are paid before ordinary shares, the Investor will recover some or all of their money before other shareholders share in the proceeds. An Investor may also have some ordinary shares to give him a percentage of the higher exit valuations.

Some Investors use options to provide additional incentives to the entrepreneur and senior management to allow them to accumulate additional equity in the business. The options may be set against certain milestones or performance targets which represent higher potential exit proceeds. The entrepreneur gains a greater percentage of the proceeds as the options kick in at higher exit valuations.

An anti-dilution clause in favor of the Investor in an investment agreement has the effect of protecting some or all of their investment in the event that the valuation falls with a subsequent funding round. This clause adjusts the shares of the Investor so that their original investment retains its monetary value under the new valuation. In this situation, it is the original founders who

suffer the negative adjustment. However, this type of adjustment is typically not readjusted with a subsequent higher valuation.

Finalising the Investment

Most formal Angel and VC evaluations follow a similar staged process. This approach is commonly used by an experienced Investor with many investments and by Angel syndicates, Angel Groups and VC firms. Individual Angels often go by their gut feel or a 'seat of the pants' judgement, however, fewer mistakes are likely to be made with a more systematic and comprehensive process. Also, if other Angels are investing at the same time, the individual Angel doing the evaluation would be better able to later justify and defend an investment recommendation if a more formal process was followed. Given the high level of Angel syndicate investments over the past several years, the process set out here will apply to an Angel co-investment situation.

The purpose of the staged process is to eliminate, at the earliest possible time, those investments which fail to meet the criteria established by the Investor. Each successive stage involves higher levels of expenditure on time and professional services and investigation expense. Only very few firms progress to the later stages.

The overall duration of the process will vary according to the complexity of the proposal and the ease with which the detailed investigations can be completed. Larger Angel syndicates and VC firms can be expected to have more formal processes and perhaps more sign-off stages. It is unlikely that funding

would be provided in less than three months with the average taking closer to six months.

(a) Initial contact

The better and more established Investors prefer to receive their initial contact through a referral. However, whether it comes with a recommendation from another Angel, professional services firm, personal contact or simply through the mail, the initial review of the proposal will be a quick read of the executive summary to see if the size of funds required, the stage of investment, the industry and the geographical location are of interest. If interested, the Investor will ask the Entrepreneur and one or two members of the senior management team to come to a brief meeting where the proposal will be discussed.

(b) First formal meeting

The purpose of the first meeting is for the Investor to evaluate the Entrepreneur and the management team. The Investor should set the expectation that the management team should come prepared to answer detailed questions about all aspects of their business. They may be asked to do a formal presentation on the business opportunity for 10-30 minutes.

(c) Exchange of information

If the initial meeting goes well and both parties are interested in going forward, the Investor would normally request a business plan (if the management team has not already provided one) as well as contact details of other executives in the firm, names of referees, key customers, suppliers and distributors. The firm may be unwilling to provide confidential information at this stage but should provide sufficient information for the Investor to decide if they wish to expend more time and expense on evaluating the investment.

(d) Informal due diligence

The Investor would normally conduct a limited investigation into the market, the firm and the business proposition. This will often involve contacts with industry executives they already know or with other Angels or VCs active in the sector. The Investor might also visit the offices of the firm and interview the key executives and key employees. The market analysis would normally include

an investigation of competitors and some validation of the customer benefits associated with the products or services offered by the firm.

(e) Term sheet negotiated

The Investor would then brief the firm on the evaluation of the proposal and the terms under which an investment would be undertaken. During this discussion the Investor and firm agree a valuation or valuation formula, discuss costs and fees and decide on the equity to be taken by the Investor.

(f) Investor quality review

Before proceeding to issue a term sheet, the Angel syndicate or VC firm may wish to have the proposal presented to them with a justification of the investment to be made. This is an internal check to ensure that due process and adequate product/market opportunity evaluation has been carried out. The presentation would normally include a limited financial model of the business over the likely term of the investment. Additional analysis may be required following the discussion and before individual Angels or the VC Fund issue the term sheet. Larger deals may require more extensive and expert investigation. In these situations the Investor may outsource part of the work to professional services firms and specialist market analysis consultancies.

(g) Term sheet issued

Once the initial due diligence has satisfied the Investor that the investment should move forward to a detailed investigation, the Investor would issue a formal offer in the form of a heads of agreement called a term sheet. This sets out the terms and conditions under which an investment will be made if the proposal satisfies a more detailed and formal due diligence investigation. The term sheet is not binding on either party at this point. However, the Investor may expect the firm to deal exclusively with them during the detailed due diligence period.

(h) Investment approval

Once the term sheet has been issued and accepted by the firm, a more extensive financial modelling exercise may be undertaken to help other Angels or other VC Fund partners understand the risks and opportunities in the deal. This analysis would look at the likely investment returns under different risk

conditions. Exit strategies will be formulated under different performance assumptions. Once this additional work has been undertaken, the proposal will again be reviewed, perhaps by a larger number of Angels or the full investment committee of the VC Fund. Larger Angel syndicates and VC Funds will have a formal authorisation process for the detailed investigation. This protects the syndicate and VC firm from an over enthusiastic Angel or investment manager and allows a wider range of expertise and experience to review the proposal before the syndicate incurs the expense of a detailed due diligence investigation.

(i) Formal due diligence

Upon signing the terms sheet, the Investor and their professional advisors will examine the company's corporate structure, assets, intellectual property, financial statements, material contracts, employment agreements and any actual or threatened litigation. Technical specialists may be hired to review R&D results and plans, specialist equipment or foreign market plans.

(j) Formal approval

Once the detailed due diligence has been completed the proposal is reviewed again to ensure that risks have been adequately assessed. If the Angel syndicate or VC firm is still comfortable with the investment and the ability for the lead Angel or investment manager to manage it, formal approval will be given to go forward with the investment.

(k) Legal documentation

Upon completion of due diligence, parties typically prepare and sign the following formal legal documentation:

Subscription agreement: which sets out the number and price of shares, funding tranches and dates of subscriptions, detailed warranties concerning the company, rights attaching to shares and conditions precedent to funding. Subscription agreements may also cover future subscriptions by the Investor, the founders, other shareholders or key staff and ratchet mechanisms to re-allocate shares in the event of over or under performance by the business.

Shareholders agreement: which sets out the ongoing relationship between the shareholders and the company as agreed in the term sheet.

Intellectual property acknowledgment deeds: is an acknowledgment by other parties that they have no rights to any intellectual property which they develop and assigns all such creations to the company.

Executive service agreements: will bind 'key' employees to the company for a period (usually two or three years), and will set out the employees' terms of service, remuneration and bonus entitlements.

Source: <http://www.oznetlaw.net/facts.asp?action=content&categoryid=226> Accessed 31/12/04

Once the final documents are signed, the Investor will issue the first tranche payment to the firm. Follow on payments will be made under the terms of the agreement, but may be subject to performance achievements.

Normally the investee would be expected to reimburse the Investor for all the expenses associated with making the investment if the investment is made. If an investment is not made, only where the firm has misrepresented material facts or withdraws after the due diligence costs have been incurred will the Investor expect to recover their investigation costs.

Where an investment is made, the firm would normally reimburse the Investor for the external expenses incurred in the due diligence process. This would include professional fees and external consultant's costs and will occur with or without a transaction proceeding. Even on a small investment these can be expected to be \$50,000 to \$70,000. For a larger deal, it could easily exceed \$250,000. Some funds charge an advice fee if they have helped to structure part of the deal with external parties. If the venture is relatively small and the product/market issues are straightforward, it may be sufficient for the Investor to undertake a limited due diligence and use a regional or local professional services firm thus cutting down on the costs.

The Investor is normally appointed as an external Director to the firm and the company would normally be expected to pay a Director's fee, in most cases it would be around \$15,000 to \$25,000. Larger companies will incur higher Directors' costs.

Some Angels and VC firms charge an annual management fee which might vary but often can be around 1% of the amount invested.

Term Sheet and Deal Structure

The term sheet sets out the terms and conditions of the investment in the firm. Term sheets can vary in length and complexity but would normally contain, at least, the following clauses:

- The number and price of the shares in the company to be purchased. These are normally set up as preferred shares with cumulative dividends (where declared). The preferred shares would normally be paid out in full prior to any payment to ordinary shareholders in the event of the liquidation or sale of the firm. This section would also state what other shares are issued as well as the capitalised value of the business. The value of the business is then used to calculate the percentage of the shareholding that would be owned by the Investor subsequent to their investment. The preferred shares are normally converted to common shares on liquidation or exit. However, in the event of failure, the preferred shares are entitled to first call on the liquidation proceeds. The Investor would normally be entitled to at least one seat on the Board of Directors and would have certain veto powers or power of approval over:
 - the capital expenditure budget
 - the annual operating budget
 - any debt or asset lien over a specified value
 - appointment of CEO, CFO and senior executives
 - remuneration and employment conditions of senior management
 - any issue of additional shares
 - a change in the number of Directors
 - any dividend
 - any major change in structure, assets, merger, acquisition or disposal

- the use of the invested funds.
- The Investor may require their percentage of the total capital of the firm not be reduced in a subsequent share offer at a price lower than the one they came in on (anti-dilution rights).
- The Investor will be entitled to ‘piggyback’ the registration of their shares with other shares being registered for sale.
- If at least 75% of the shareholders accept an offer to sell the company the balance of the shareholders agree to the same conditions of sale (‘drag along rights’). This may be extended to enable an Investor to ‘drag along’ the other shareholders where the Investor accepts an offer to sell shares after an agreed period of time.
- The Investor has the right to purchase shares in any new issue of shares in the same percentage as their holding.
- If a founder has an offer to sell his/her shares, the Investor has the right to participate by selling the same percentage of their shares (‘tag along rights’).
- The Investor can require their shares be purchased plus accumulated and unpaid dividends after a specified date in specified stages (redemption rights).
- The offer to invest will be conditional on adequate due diligence and the production of various documents.
- The offer is confidential and will only be open for acceptance for a specified period of time.
- Each party will be responsible for its own professional fees.

The term sheet is an offer to invest. Until accepted, any terms and conditions can be negotiated, although many of the terms and conditions are standard and are unlikely to be varied since they protect the Investor in the event of the business failing to meet their objectives.

In most circumstances term sheets are not legally binding, but provide guidelines on matters to be documented in subscription and shareholders agreements.

An example of a term sheet is provided by the British Venture Capital Association under the title *Example of a Term Sheet for a Series A Round* (see www.bvca.co.uk). While these are local UK legal documents, the terms are very similar to those which would be present in most other legal jurisdictions. Another example is given at:

http://www.angelblog.net/The_One_Page_Term_Sheet.html

In most cases the term sheet is issued prior to the completion of due diligence. As such the Investor will usually reserve the right to amend the terms of the term sheet should anything of concern be found during the due diligence process.

Due Diligence

Once the Investor has issued a term sheet and this has been formally accepted, the Investor will proceed to a full analysis of the investment opportunity. At this point commercial analysts, lawyers and accountants acting on behalf of the Investor will undertake a due diligence investigation. The Investor will incur considerable costs in this investigation and will want to ensure that the firm is acting in good faith during this period. To protect himself, the Investor will normally request the firm execute an exclusivity agreement where the firm agrees not to seek investment from any other party during the due diligence period. A penalty may be agreed for a breach of this condition.

One objective of the due diligence process is to investigate the firm to see if the business itself has any major problems which have not been identified in the information already provided to the Investor. The due diligence process will undertake a validation of all aspects of the existing business as presented in the business plan. This would include most of the following:

- background checks on the key executives and key employees
- review of all financial information and additional investigations where necessary to validate key numbers
- inspection of all key contracts
- interviews with major customers, suppliers and distributors

- verification of costs, expense levels and purchase commitments.

This process will check the integrity and honesty of the firm as well as provide a view on how well the business is managed and on the adequacy and accuracy of the information which is being used in the business. It will also uncover how well the key executives understand their own business and the ease with which they are able to access and provide additional details necessary to the analysis.

A key part of the due diligence process is for the Investor to identify anything which would incur additional costs, create delays or expose the business or the Investor to actual or potential liabilities not identified in the information provided to the Investor. Items which frequently create problems include:

- non-standard customer contracts
- non-standard supplier agreements
- harsh lease conditions
- loose IP agreements
- overly generous reward and remuneration systems
- generous health or vacations benefits
- shareholders' rights, legal structures, joint ventures, option schemes and anti-dilution arrangements
- poor reporting systems
- out-of-date equipment
- poor quality products or services
- personal use of company funds or resources
- pre-existing obligations, rights, commitments or restrictions
- non-standard rights of existing debt holders.

A business which is effectively and efficiently run, has good customer, distributor and supplier relationships and has good internal reporting systems which monitor performance, ensure adherence to compliance regulations and protect the business from mistakes, should have few problems in satisfying the Investor.

After the firm has satisfied the Investor with regard to its current operations, the Investor will examine the business projections and other planned targets and milestones which underpin the business plan. This is the area which exposes

the investor to the greatest risks. This investigation will review the following:

- the identification of the prospective customers and the quality of the benefits the customers gain from the product or service
- the size and growth rate of the prospective market
- the size, strength and strategies of current and potential competitors
- the quality of the intellectual property underpinning the business plan
- the quality of the sales, marketing and distribution strategies proposed
- the likely ability of the management team to be able to execute the business plan
- availability of executive and specialised staff needed to grow the business
- the quality of the exit strategy proposed
- the likely cash flow over the expected investment period.

To the extent that uncovered risks reduce the probability of achieving the desired outcome or delay the time to execute, the value of the potential investment declines. In some cases problems can be overcome by installing additional controls, renegotiating agreements and putting in place alternative strategies. However, these may result in additional costs or delays in executing the business plan. To the extent that problems cannot be easily resolved or the entrepreneur is reluctant to make changes, the investment will incur greater risks. At some point the investor will decide that the risks are too great and will decide not to make the investment.

If the investigation results in an agreement to proceed with the investment, the firm will most likely incur the costs of the due diligence plus the legal fees associated with the preparation of the investment agreement. Fortunately, emerging businesses are often quite small and the amount of investigation needed to understand their current operations is also small. Due diligence costs should be reasonable relative to the size of the investment.

Part B of this book sets out an ideal operations checklist against which the current business can be measured. Start-ups and early stage firms are unlikely to have sophisticated control and reporting systems in place, but these can be introduced over time as the business develops. The checklist can form a guide

to the development of the governance and operations management within the firm as it prepares for its next stage of growth. Firms which anticipate accessing venture capital or expect to undertake an IPO will need to score highly across all elements of the operations Index.

Conclusion

For the entrepreneur to dramatically increase the probability of successfully raising Angel or Venture Capital finance he needs to create a business proposal with these characteristics:

- a well-articulated and highly probable exit strategy within three to five years;
- a detailed plan to achieve the exit conditions;
- an experienced executive team that can deliver on the plan;
- a product/market opportunity that has sufficient competitive advantage that it has a high probability of reaching the exit conditions; and
- an initial valuation and a likely exit valuation that will provide the VC fund with a 25%+ plus ROI.

The entrepreneur needs to accept at the outset that there is a high probability that the exit will be by way of a trade sale, in which some of the executive team may be made redundant. Even if an IPO strategy is planned, a trade sale should also be considered as part of exit planning.

The successful entrepreneur creates a business opportunity which meets the objectives of the Angel or the VC fund, not the personal ambitions of the executive team. Private equity investors are not solely in the business of building firms or the commercialisation of inventions. Whilst this may be a by product of

their investment, their principal focus is simply to invest their own funds or the funds of their private investors and administer that investment to an exit to gain a high rate of return to the investors. In the case of the executives of a VC fund, their personal remuneration is tied to that of their investors and their future tied to the total return on the fund, thus their motivation is the return on the investment, not being nice to the entrepreneur or keeping the business going.

The entrepreneur who creates a business opportunity which meets these needs has a high probability of raising finance.

PART B

Investor Ready Indices

Introduction

Angels and VC investors typically invest in start-up or early stage ventures where the business is somewhat unsophisticated, management often inexperienced, products are in development or in their early release stage and internal systems are poorly developed. In these circumstances it is unrealistic to expect that the business will be as ‘investment ready’ as it would be for an expansion stage or late stage venture capital investment. Therefore, instead of measuring the business proposal against an established business, the Investor will look at the management team and the underlying assets and capabilities of the business and try to measure whether it has the potential to emerge into a profitable, sustainable, growth business or a strategic value business which could provide the Investor with the exit they desire.

Anticipated development of the business should provide the potential of taking the firm to an ‘investor-ready’ state if further capital injections are required. At the same time, the Investor should be preparing the business for a trade sale, since this is the most likely exit path. An IPO is unlikely, but possible; the Investor should keep this in mind as they investigate the business and help it grow and develop.

Part B sets out pre-investment selection criterion of the prospective investee firm. The first evaluates the alignment of the investee shareholders and

management and then there are three major development charts; the first assists the Investor to evaluate the venture potential and the second provides a means of guiding the development of the internal governance and management processes and systems which will be needed for an effective exit. Using these Indices, the Entrepreneur can judge the attractiveness of the venture for outside finance. Finally, the Strategy Index guides the entrepreneur on the process of raising finance.

The Awareness and Alignment Index (AAI) has been designed to capture the attitudes and preparedness of the entrepreneur, shareholders and management team of the business to a possible injection of external capital. Using the AAI, the Entrepreneur can work through the issues which will confront the Investor as he assesses whether the management and shareholders are ready for an injection of external equity finance. The Entrepreneur can use the AAI to prepare the venture for investment.

Once the Investor is convinced that the firm understands the nature of an external equity investment and the impact it will have on the current managers and shareholders, the Investor will then use the Venture Potential Index (VPI) to measure the quality of the investment proposal. The VPI provides a systematic method of measuring the quality of the business concept in terms of its ability to support development of the business to a point where a profitable exit can be achieved. An investor ready business is generally regarded as one in which an Angel or Venture Capital (VC) fund would be keen to invest. The list of attributes has been refined in consultation with a number of successful entrepreneurs who have raised venture capital, a number of private equity professional advisors as well as a number of venture capital general partners.

The Entrepreneur who is keen to develop their business using external private equity can use the VPI to measure their 'investor ready' state. Where they see deficiencies, they can, where possible, adjust their business concept, change products, markets and organisational structure and so on, to create a better candidate for investment. However, a venture which scores low on the VPI and which cannot be readily changed, will be an unlikely candidate for external private equity finance.

The Entrepreneur should also be sensitive to the fact that the VPI keeps in

mind the potential for a trade sale exit and assesses whether the venture has the potential for either a financial or strategic exit.

The next Index is the Operations Development Index which (ODI) should be used as a checklist in evaluating the quality of operations management in the venture. Its primary purpose is to provide a guide for the development of governance and operations management once the investment has been made and to indicate to the Investor how much work needs to be done to prepare the venture for an exit. A business which scores more highly on the ODI will be a venture which is easier for the Investor to work with and will be better positioned for an early exit. Certainly those firms which achieve a higher score on the ODI will be more effectively and efficiently managed and so allocating resources to improve their situation according to the ODI would benefit day-to-day operations.

Raising Angel or VC finance is a process which needs to be managed over time. There are a series of actions which need to be taken both within and outside the firm to secure the investment. The final Index, Strategy, provides a process whereby the firm can assess its progress towards closing an investment proposal.

Each attribute of the Indices helps to define the state of readiness of the firm either for investment or exit. It is unlikely that any firm would have an ideal position on every item; however, the scoring will indicate where improvements can be made or problems addressed. The AAI will show the Investor where the firm is currently in their preparation for external investment and should be used by the entrepreneur to stimulate discussion and action within their firm to ensure the firm is better prepared for initial discussions with an external investor.

The VPI can be used to undertake an initial evaluation of the likelihood of being able to secure investment and then later to guide development of the business to an investor ready or exit objective. The ODI will help identify just how well developed internal processes of governance and operations management monitoring systems are and guide development work on their implementation and improvement. In many cases, specialist assistance will be required to implement changes needed to reach higher Index scores.

The purpose of the Indices is to help the Entrepreneur evaluate their own chances of securing investment and to manage the process of securing the investment. The first three Indices mirror what an Angel or VC investor will evaluate in assessing the venture for investment. It is thus a comprehensive and systematic way of investigating a proposed investment and should help isolate any serious deficiencies in the proposed business. Each question or attribute will provide an insight into the business and the work which will be needed to make it investor ready.

Angel and VC investing is a process not an event. Historically, many Angels and VC Investors thought that they could rely on their gut feel or on their evaluation of the entrepreneur and a quick walk around the firm's offices to judge the quality of the investment proposal. While these factors are important, the investing process has become much more formal and sophisticated, especially through the development of formal Angel syndicate investing. Angels and VC investors now appreciate that a systematic and comprehensive review is more likely to catch fatal flaws and problems.

In many cases, the effectively managed firm will score highly on an attribute. In other areas, where no attention has been given to preparing the business for an external investment, little will have been done. By scoring these attributes, you will find out the status of the business and identify what needs to be done to prepare it for external investment. Alternatively, you may find out something which will cause you to abandon seeking external investment.

The Indices are constructed with an 'attainment' or 'achievement' scale of 1-5. To complete an Index, you should circle the description which is closest to the current position.

Nothing done	Little progress	Reasonable progress	Significant progress	Fully attained	N.A.
1	2	3	4	5	

N.A. = Not applicable

Once you have identified where the firm is on the attribute, you will be able to see from the later descriptions the actions which you might need to take to turn this venture into one which will attract Angel or VC investment.



Awareness and Alignment

Angel and VC investment is beneficial for many businesses, but it is not for everyone. In fact, it may directly contradict some shareholder's plans for the business. At the same time, the venture may be inappropriate for an external investment. What is clear is that the shareholders and senior management team should understand the domain and objectives of the Investor and seriously consider whether they are willing to meet the conditions and obligations inherent in that type of investment. The business which is able to show the potential for a successful exit sought by an Investor would stand a good chance of gaining Angel or VC investment, but the conditions which come along with the investment may still be unacceptable to the business. Thus some education in this area is certainly beneficial for anyone considering this type of investment.

Once the nature of an Angel or VC investment is understood, there still needs to be a clear understanding on the part of the shareholders and management as to the objectives to be achieved through the investment. Those objectives need to be aligned closely with those of the Investor.

A1. Majority shareholders agree on an external equity financing strategy

The obvious implications of an external investment are:

- A dilution in existing shareholders' equity.
- Some constraints on executive decision-making, especially with regard to the issue of shares, extensions of debt and executive remuneration.
- Management will be expected to agree to various performance targets. Failure to achieve those may result in a loss of voting rights, termination of management contracts and the business being sold.
- Internal systems will become more formal and a higher emphasis will be placed on record keeping, governance and compliance.
- A formal Board of Directors will be required (if it does not exist already) and the Investor will almost certainly want at least one position on that Board.
- An exit strategy for the Investor will most likely have to be achieved within 3-7 years. This may be in the form of a buyback, trade sale or IPO.
- Additional rounds of capital injection may be required from Angels or a VC.

The majority shareholders need to seriously consider the implications on their own ownership positions and, where appropriate, their roles as managers and directors. The majority shareholders need to agree on the need for the external investment for there to be an effective plan to proceed to raise the investment.

Self-assessment

1. Discussions have not been undertaken with or between the major shareholders.
2. Majority shareholders have talked about taking on an external investment but have not taken the discussions seriously or established any consensus about timing.
3. The shareholders have agreed on raising external capital but as yet have not decided on a strategy.

4. The majority shareholders have agreed how they will approach the project of raising external capital and have formulated a strategy but have not taken professional advice on whether the strategy has a reasonable chance of success.
5. The majority shareholders have refined a strategy in conjunction with a professional advisor.

A2. Managers and owners agree on use of funds

Any approach to an external investor should be able to show how the use of the investment funds will directly contribute to the development and growth of the business and to achieving the objectives of the Investor. Too often applicants seeking Angel and VC investment are focused on solving business problems, refinancing an ailing business, buying out a shareholder or trying to build a cash buffer, rather than directing their attention to providing the external investor with an outstanding opportunity. Even where there is an obvious investment opportunity, there may be disagreement among the managers and owners over how the growth and profit objectives are to be achieved.

Angel and VC investors are rarely experts in a specific business, especially when a business works with complex technologies or is based on specialist knowledge. Thus the investor is reliant, to a large extent, on the managers of the business to come up with a resilient plan to achieve the growth objectives needed to satisfy the investment objectives. Unless the management have taken the time and effort to develop such a plan, disagreement is likely to occur in the management team as the investor digs into their intended strategy. Nothing is likely to kill off a deal faster than an investor being exposed to a lack of agreed strategy or a team which clearly is not in synch.

The management team needs to be able to show the Investor a robust business plan which incorporates the use of the investment funds and shows the expected growth of the business and how the objectives of the Investor can be achieved. This needs to be endorsed by the majority shareholders and by the current Board of Directors. To ensure the plan is consistent with the requirements of the Investor, it should be presented in a way that the Investor can evaluate it and build an investment proposal for discussion with any co-investors. It would be helpful to the Investor if the business plan had been reviewed by

professional advisors who work frequently with Angel and VC investors. This would be helpful to the Investor as the professional advisor's recommendations for layout, style and detail and any changes they advise on the use of the funds could be agreed with management and majority shareholders and incorporated into the business plan before it is sent off to the Investor for evaluation.

Self-assessment

1. Senior management and majority shareholders have not discussed how any investment would be used.
2. Discussions have been held by senior management but there is no consensus on how or where the funds will be used.
3. Managers and majority shareholders are agreed on the priorities for the use of investment funds but have yet to integrate this into a proposed investment business plan.
4. A detailed investment business plan has been created which shows how an external investment would be utilised and has identified the results which would accrue to that investment; however, professional advice has not been sought as to whether this would meet the needs of the Investor.
5. Professional advice has been sought on the use of the funds and adjustments have been made to the investment business plan to incorporate that advice.

A3. Entrepreneur and key managers are committed to the venture

Without the entrepreneur and the key management team the venture is unlikely to be successful. The Investor needs to see a commitment on the part of the key individuals to ensure they will put their best efforts into the venture. The Investor is not a full-time member of the management team and so is reliant on the entrepreneur and the management team to take the business forward. The business has to be operated on a daily basis by those most committed to it, even if the task becomes onerous or stressful. The Investor wants to see that these individuals have something at risk if the venture fails and much to gain if it is successful. The Investor needs to have some assurance that members of the

team won't bail out when things go wrong or when they need to step up their commitment to see the venture through hard times.

A condition of many external investments is to have senior management share in the risks as well as the rewards. This may be through an equity stake, employee options, generous bonuses on successful completion of milestones and/or a bonus on a successful exit. A business which does not reflect this balance of risk and reward for key individuals will need to implement ownership and bonus structures which provide the Investor with an assurance that the key individuals are committed to making the venture successful.

Self-assessment

1. The firm has not considered this issue. Some key individuals do not have equity or options and bonus systems are not in place to motivate long-term commitment.
2. Most senior management have equity but, for some, their allocation is not at a sufficient level to ensure long-term commitment. Small bonuses are possible on achieving individual objectives.
3. Each of the senior management team has adequate incentives in the form of equity and/or options to be committed to the venture. Other key employees have bonuses for personal achievement.
4. Senior management and key employees have equity and/or options sufficient to motivate them to stay committed to the venture. In addition to personal bonuses, there are corporate-wide bonuses for major milestones. The system of rewards has not been reviewed by a professional advisor to ensure it would be sufficient to support an external investment.
5. The allocation of equity and options and the system of bonuses have been reviewed by a professional advisor and adjusted to assure an Investor that it provides a good basis for key executive and key employee commitment to an external investment.

A4. Key shareholders are familiar with exit conditions

External investors are faced with a lack of liquidity when it comes to recovering their investment in a private business. Generally few investors wish to hold a minority position in a private company as they have little control over the events of the business and generally are unable to recover their money when they need it, especially if the business gets into trouble. Thus the investor imposes on the firm a series of conditions which will effectively force the business to undertake a liquidity event within a reasonable period of the investment, say 3-7 years, in order for the Investor to recover their money and hopefully achieve a reasonable return on their investment.

The exit conditions are mainly as follows:

- If an offer is received for the business, the Investor may force the shareholders to accept it.
- If the shareholders wish to sell their shares, they will not be able to do so without selling those of the Investor.
- The business may need to undertake an IPO within a set period or, failing that, be put up for sale.
- The existing shareholders may be required to buy back the shares of the Investor after a certain period where failure to do so would result in the sale of the business.
- Failure to achieve agreed performance targets may result in the Investor taking control over the business. Once this is achieved, the Investor might decide to sell the business in order to liquidate their investment.

Self-assessment

1. Key shareholders have little or no knowledge of Angel and VC investment conditions.
2. Key shareholders are agreed which the firm could be sold if they fail to meet targets but are unaware of how this would work operationally.
3. The key shareholders are aware of the different conditions which will be imposed on them in terms of the performance requirements of the Investor but senior management and majority shareholders have not

discussed how this will work or how they will manage the business to meet those targets.

4. Senior management and key shareholders have developed an external investment plan, with events and targets which senior management believe are achievable, which will meet the management and exit requirements of the Investor and still leave them in control during the investment phase.
5. The firm has engaged a professional advisor to brief them on the investment conditions of an external Investor and has reviewed the investment plan to ensure that management has a reasonable chance of meeting the Investor's conditions.

A5. Cost and time for raising funds is understood

Few entrepreneurs appreciate the level of time, effort and costs which they will incur during the process of raising external investment. Those who have been through the process estimate that 50% of the CEO's time and much of the CFO's time over a period of three to nine months will be consumed with preparation, presentations and negotiations. In addition, the due diligence activity can easily consume many months of staff time. During this process, the business has to be directed and managed without impacting on revenue and profit – a very tall order indeed.

Better preparation can considerably ease the burden on the executive team and administration staff. This may include compilation and update of due diligence files, a periodically updated business plan, regular and comprehensive monthly management reports, compliance audits and performance reviews based on key performance indicators and budgets. By working with knowledgeable advisors during preparation for an investment, the time to find the right investor will be cut and the discussions streamlined as the executive team will be better prepared for the negotiations.

An Investor will want to spend time with the senior executives to get to know them and to develop an understanding of the business. This will take most senior executives away from the business for significant portions of time. The business needs to have a plan in place so that the rest of the executive team can carry on without undue disruption to the flow of activity.

Self-assessment

1. Senior management and majority shareholders have not discussed the time and resources required to raise external investment.
2. The firm has some idea of the time and effort required but has yet to allocate these or consider how the business will operate while senior management is diverted into that activity. The cost incurred to raise funds has not been estimated.
3. Advice has been sought on the process of raising investment and the amount of time and effort has been clearly identified but responsibilities for activities and succession plans have not been planned or agreed. The cost incurred to raise funds has been estimated.
4. Responsibilities for the investment raising activity have been allocated but responsibility for managing the ongoing operations has yet to be clearly allocated and assigned.
5. A plan has been agreed with senior management and subordinates with respect to roles and responsibilities for undertaking the investment activities as well as the running of the day-to-day operations. A budget has been allocated for the costs associated with raising the investment.

A6. Board of Directors accept authority limits of an external investment

Many immature businesses seeking external investment have little experience with formal Boards of Directors and will find the process of setting up a Board and handing over authority for significant strategic decisions very uncomfortable and often frustrating. No longer can the executive team meet whenever they feel like it and make a decision which materially affects the shape of the business. More developed firms which have constituted a Board of Directors may have friends and family on the board and perhaps a trusted family advisor, such as a local lawyer or accountant. With the introduction of the external investor, the role of the board will change markedly and the existing executive directors will have to justify their actions, defer major decisions to the Board and allow the Investor to have the final say on a number of strategic activities. This can be very confronting to the entrepreneur who is used to having the Board rubber stamp his or her actions.

The investment agreement will specify that a number of activities can only be taken with the approval of the external director. This would almost certainly include issuing new shares, declaration of a dividend, changes in senior management remuneration, changes in levels of debt and approval of capital expenditure. The following descriptors refer to the Board of Directors prior to an investment.

Self-assessment

1. The Board of Directors have little understanding of the authority limits imposed under an Angel or VC investment.
2. The Board of Directors understand that there will be some constraints on decisions they make but are unfamiliar with the type and extent of such limits.
3. The Board of Directors has reviewed a list of the limits on authority which will be placed on them by an Investor but have yet to translate these into operational or strategic impact.
4. The Board of Directors understands and accept the limits on their authority imposed on them by an Investor but have yet to translate this into operational details and procedures.
5. The Board of Directors have reviewed the authority limits imposed by an external investment with a professional advisor and has implemented various limits on the authority of management and established procedures for how issues relating to those items will be handled in Board meetings.

A7. Post-investment management roles and responsibilities accepted

Experienced Investors place great emphasis on having the right management team in place. This reflects the wisdom of having an experienced team with the right mixture of qualifications, skills, networks and industry experience but also the lessons learned over the years by Angels and VC Investors that few plans are implemented as expected. The experienced entrepreneurial team adapts to changing circumstances and copes well with unforeseen events. The current management team will be thoroughly scrutinized and gaps exposed.

The Investor may well suggest (and impose) management changes either through a new alignment of roles and responsibilities or the introduction of new executives.

Clearly it is in everyone's interest to have a successful venture. The business which sees an investment as an opportunity to introduce new talent into the business will be well received by the Investor. Finding experienced executives who have experienced growth to the level the venture needs to achieve can make all the difference in the success of the venture. At the same time, the entrepreneur will need to acknowledge that some of his current team may be inappropriate for the new growth plan. Regrettably that means that some of the current executives may lose their jobs or be relegated to more junior roles. Understanding that such changes may occur and being willing to work through them to find the best overall solution, will be critical in securing an investment.

Self-assessment

1. Senior management and majority shareholders are not aware that any changes could or would be made to their senior management team or their responsibilities.
2. Senior management have reviewed their management experience and functional expertise and experience and have determined that they have some gaps but are yet to develop a plan to address them.
3. Specific skill gaps have been identified in the management team. Senior management and majority shareholders have acknowledged that the Investor may require changes in responsibilities, a new organisational structure or some new senior executives. However, this has not been accepted by senior management and they have not accepted that it might be a condition of the investment.
4. Senior management and the majority shareholders have acknowledged and agreed that they lack a number of skills, the organisation structure may need to be changed, an Investor may require some new executive talent and their current roles and responsibilities are most likely to change.

5. A professional advisor has reviewed the management team, organisation structure and responsibilities and proposed changes in structure and roles. The advisor has also helped the firm to develop a proposal for filling gaps in the management team which has been included in the investment plan. The current management acknowledge that an Investor may have a different view and the new structure and roles will need to be negotiated and agreed with the Investor.

A8. Angel and VC valuation models are understood and accepted

Many deals are never concluded or, in fact, never proceed to substantial business negotiations because the majority owners have quite unrealistic views about what the business is worth. It is important that the firm seeking external investment have some understanding of valuation methodology. While it is always possible for valuation formulae to be used which are based on performance or on an exit value, it is unlikely that this will be agreed in the early stages of the discussion.

It is important that each party accept the valuation norms of the Angel or VC investment sector prevailing at the time they are seeking investment. This way valuation does not get in the way of the negotiations proceeding. Variations to the norm can then be negotiated based on how future risks may be translated into equity share. The process set out here provides a basis for negotiating value but it starts with an understanding of conventional valuation techniques. From that point, the entrepreneur or Investor can argue for a variation which perhaps better reflects the risk tolerance of each party.

Few entrepreneurs have current knowledge of what is happening in the Angel and VC investment sector and this is where access to knowledgeable advisors can be a great help. The advisor can provide the entrepreneur with information on current transactions and also work with the firm to develop a valuation which could be used in the investment discussions. An Investor will recognise that the entrepreneur has sought professional advice and will be expecting that the valuation proposed will be close to the final negotiated value.

In the case of a potential strategic trade sale, the entrepreneur or the Investor may have some view on the value to the potential buyer and this may be used as a basis for a valuation discussion.

Self-assessment

1. The firm has no appreciation or knowledge of how an Angel or VC Investor will establish valuation and equity arrangements.
2. The firm understands conventional valuation formulae and anticipates that this will be used by the Investor as a basis for negotiation but has no real understanding of how the final valuation and equity share will be determined.
3. The firm has some familiarity with valuation techniques used by the Angel and VC investment sector and some knowledge of how equity will be structured following an investment but does not have a good understanding of how this might be applied in their venture.
4. The firm has built a valuation model based on conventional Angel and VC valuation methods and has determined what they believe will be a reasonable basis for valuation and equity share but has not had this validated by a professional advisor.
5. The firm has engaged a professional advisor to assist in the development of a valuation and equity share model which would be acceptable as a basis for negotiation with an Investor.

A9. Level of finance required is realistic

What can go wrong will go wrong. Perhaps not – but this is the view which most Investors take when evaluating the level of investment required to provide a firm basis for development of the venture. Under-funding during the critical growth stages can place the business in a desperate situation where product development is not quite finished, cash flows are not yet positive or market development has not reached a critical turning point. Typically, the only option firms have at this point is to seek a further injection of cash. Unfortunately this can often only be achieved at a valuation lower than the one established when the initial Angel or VC investment was made. Investors will negotiate hard to avoid this situation.

A realistic view of the funds needed can only be achieved through a thorough simulation exercise of the venture. Various scenarios need to be created across a range of possible outcomes which include worse case, most likely and best case situations. In this way, the sensitivity of the venture to the level of funding needed and the estimated return to an Investor can be ascertained. With this knowledge, the firm can better negotiate the investment. It may be possible for the investment to be taken in tranches to reflect funding needs and for the equity position to be adjusted accordingly. The Investor can then set aside the maximum likely investment funds but recognises that not all of it may be needed.

Self-assessment

1. Senior management has not undertaken any rigorous analysis of the financing requirements of the business.
2. The funding requirements of the current business are well known and understood but this has not been reviewed in light of the ROI requirements of an external investor.
3. The firm has considered the ROI requirements of an Investor and has considered the impact this might have on the business strategy and but has yet to translate this into the business plan.
4. The ROI requirements have been worked into the business strategy and into the operational business plan, establishing the level of funding which would be required from an Investor, but this has not been reviewed by a professional advisor.
5. A professional advisor has reviewed the funding requirements, requested a sensitivity analysis on the strategy and assisted the firm to establish the level of funding they believe an Investor would be expected to provide in order that the investor's desired ROI has a reasonable chance of being achieved.

Awareness and Alignment Index

Nothing done	Little progress	Reasonable progress	Significant progress	Fully attained	N.A		
1	2	3	4	5			
Item	Attribute	1	2	3	4	5	N.A
A1	Majority shareholders agree on an external financing strategy						
A2	Managers and owners agree on use of funds						
A3	Entrepreneur and key managers are committed to the venture						
A4	Key shareholders are familiar with exit conditions						
A5	Cost and time for raising funds is understood						
A6	Board of Directors accept authority limits of an external investment						
A7	Post-investment management roles and responsibilities accepted						
A8	Angel and VC valuation models are understood and accepted						
A9	Level of finance required is realistic						

Venture Potential

The essence of any Angel or Venture Capital investment evaluation is the quality of the management team (as discussed in Awareness and Alignment) and the quality and viability of the business concept itself. That is, how and where is the money made and how does the investor get a return on their investment? The Investor is looking for a set of attributes which, in a holistic manner, provide a strong and compelling business case for an investment. Each attribute should lead to a high probability of a successful outcome. Any attribute which has a weak situation leaves a gap in the plan and can lead to failure or erosion of the business by an internal or external weakness or threat.

We need to differentiate in our evaluation of a potential investment between those ventures which are being prepared for a financial exit, a financial trade sale or an IPO, from those which are destined for a strategic exit. In a financial exit, the robustness of the business concept and its ability to generate growth in revenue and profits are critical. In a strategic exit, what we are seeking are strategic value assets or capabilities and a management team to take the venture to a strategic trade sale. In a strategic sale the buyer will be providing the horsepower to take the product or service to market, capabilities to drive revenue and profit growth may be of little consequence in the proposed venture.

The attributes listed in this Index are those which have been found to have a significant impact on the success of financial ventures. While they apply to all financial businesses, later stage businesses may already have moved past the point where they can substantially change their market position, however, these should have proven revenue and profit to show a viable business concept. Many of the product/market attributes are also critical for strategic ventures.

An Investor is unlikely to find a venture which scores highly on all attributes, but since they are constantly seeking investment opportunities, each possible deal must compete with other investment opportunities which the Investor has reviewed. The Investor is looking for those ventures which have the greatest potential and the highest probability of success. It is almost certainly the case that assistance from an Investor would improve the business, after all, this is what the Investor is looking for – an investment where they can add value through their knowledge and finance. The Investor may be able to find additional executive talent to fill out the team, connect the firm with strategic customers or alliance partners or secure a strategic supplier.

In evaluating the venture potential, it may be that the Investor, with superior knowledge of a particular market, may see greater potential than has been evidenced by the entrepreneur. For example, the Investor may know a strategic partner relationship which can be readily secured or a potential acquirer for the business. While such insights cannot be guaranteed, the Entrepreneur should seek out an Investor who has experience in their sector so that synergistic benefits can be tapped.

B1. Business and economic conditions support the venture

Ventures which are most likely to succeed are driven by significant change, whether this is in technology, legislation, consumer values or the economy. New technology often solves problems which were previously not able to be addressed or significantly enhances productivity or reduces cost in solving existing problems. Obvious demographic trends create new needs in housing, aged care, infrastructure, travel services and so on. New legislation often creates new opportunities in compliance training and auditing.

Investors look for the problem the business is solving. The more obvious the problem and the greater the imbalance between demand and supply, the more urgent the need is and the higher is the likelihood that the business will be successful. Businesses need to solve a problem or meet a need and the entrepreneur should be able to show the source of that need and the size of it. This should be able to be validated with independent data.

Self-assessment

1. Evaluation has not yet been undertaken.
2. There are changes which appear to support the venture but evaluation has not been undertaken. The proposal is based on personal opinion.
3. There are clear indications of changes which support the venture in external independent information. Validation has not been undertaken of the strength or likely duration of the need or to what extent the need is currently being satisfied.
4. Business and economic conditions which support the venture are well documented and supported by externally validated data. Informal research shows that the business need is unsatisfied and a strong demand for a solution exists.
5. Business and economic conditions strongly support the venture either through legislative changes, strong demographic changes, major shifts in consumer values, major changes in technology or major economic shifts. The proposal is strongly underpinned with validation data, expert opinion of customer needs and the lack of a currently available solution.

B2. Well articulated, focused vision of the purpose of the venture

More successful ventures have focus. They clearly know the problem they are solving and have a very good description of their customer. They are able to articulate why they exist, often in very simple terms. The purpose of creating a short, focused vision of the venture is to ensure that all parts of the business are heading in the same direction and are supporting the various parts and not undermining it. Decision-making should become easier, actions are more targeted and results can be measured in terms of where the business should be heading.

Few external investors have the specialist knowledge to evaluate the technical merit of a range of diverse business ventures. However, they can appreciate a clear non-technical statement of what the business does and the need or problem it is addressing. Nothing is more off-putting to an investor as the entrepreneur who has a product that solves everything, which will be available everywhere and should be bought by everyone. Nor do they appreciate the venture team which can't decide which of the many problems they are going to address first or which market they are targeting. A clear, focused vision statement which has been carefully crafted, matches the competitive advantages of the venture and is agreed to by the venture team, is an essential part of the investment request.

In the context of a strategic venture, the vision of the venture may simply be to prepare the business for sale. However, the venture needs to see its vision in terms of the way in which the buyer would see the vision of the acquired firm. Thus a clearly articulated vision of product/market positioning is still important.

Self-assessment

1. The venture does not have a vision statement.
2. The vision of the venture is stated in broad terms, lacks focus and may be overly technical or lengthy.
3. The vision is brief but is overly technical, too long or fails to clearly state who the customer is or the problem being addressed. The vision may be stated in terms of a product for sale rather than a problem being addressed.

4. The vision clearly states the target customer, the problem being solved and is well focused and brief but is overly technical. The vision may be focused on a single product rather than a range of problems which may be addressed within a complimentary set of products or services which could be developed and delivered over time.
5. The venture has a well-articulated vision of the business concept including the problem being addressed and the solutions which are and will be offered. The vision is brief and to the point and is stated in terms that an educated non-industry investor can clearly understand.

B3. Innovative product, process or business concept

A business which does the same as every other business in the sector will ultimately be forced to compete on price. If the product or service is the same as others in the market, then without a competitive cost advantage over the major expenses in the business, the venture has little chance of growth and certainly is not going to reach the levels of revenue and profits which the Investor is seeking. Cost advantages rarely drive significant exit values. What the Investor will be seeking are products or services which are differentiated sufficiently so they can command a premium price in a niche market.

The Investor looks for an edge. What is it that this business has or does which will provide it with a competitive advantage? This almost certainly is driven by an innovation in product, process and/or business concept. The size or impact of the innovation is a metric which conveys information about the likely competitive advantage. A substantial innovation which significantly changes the cost structure of an industry, greatly improves customer value or opens up solutions to formerly unsolved problems, provides the underpinning for high rates of growth.

Obviously, the more unique the innovation and the more the customers value the impact, the more it adds to the potential competitive advantage of the venture. Innovation which does not add to customer value may in fact detract from the worth of the venture. If the innovation adds costs to the product but fails to add additional customer value, the venture is unlikely to

succeed. Innovations which add costs but at the same time significantly improve customer value can create a solid foundation for a business.

Self-assessment

1. The product or service is the same as many others in the market.
2. The product offered has only minor differences to the competition.
3. The product has clear differentiation from others in the marketplace but the differences are not sufficient to necessarily capture customers from competitive offerings.
4. The product has major differences from competitive offerings and customers will value those differences. Products have a strong competitive advantage.
5. The product has breakthrough advantages which clearly separate it from competitors. Customers highly value the advantages and this will create a leadership position. Products are the only offering in a new emerging market or are the only products able to solve the target problem.

B4. Clear and compelling customer need

Clearly the most desirable position for any firm to be in is for their product to be needed desperately by a set of customers. This does not mean something they desire or would like to have, or even something they want to have. This refers to something they must have and, better still, must have now! You may well argue that few products can ever be so compelling but, in fact, many basic products would fit that need. Each person has a need for food and water, basic accommodation and security. Without electricity, water and sewage services, life in urban areas would be impossible. This is possibly the major reason why these services are regulated. Food is of course satisfying a basic need although there are many alternatives. But the compelling need is still there.

Some conditions do create compelling needs. Virtually all regulations have compliance requirements and associated penalties for non-compliance. A product or service which stops you from being fined or going to jail has a high compelling need to buy. Products and services which neutralise or reduce physical or psychological pain and suffering easily fall into the class of products

which have a compelling need to buy. However, products which have little impact if not purchased, have many near substitutes or can be indefinitely delayed have a low compelling need.

Some products, such as designer labels, well established and trusted brands and products with high repeat-purchase attributes have a higher score on compelling need to buy.

Self-assessment

1. The product or service has many competitive and substitute offerings and is highly discretionary or optional. Customers regard the purchase as a nice to have rather than a must have.
2. The product satisfies a clear customer desire but it is neither urgent nor pressing and can be satisfied by a large number of alternative solutions or products. Customers can decide not to buy without being overly concerned.
3. There is a clear need, but satisfying the need can be deferred as it is not an urgent need to satisfy. Customers have a strong preference to purchase and would be concerned if they were not able to. There are some acceptable near alternatives.
4. The need is obvious and of high value to the customer but may be temporarily deferred or can be partly satisfied by poor alternatives. Customers have a strong desire to purchase and would be seriously concerned by deferring the purchase.
5. There is a compelling need to purchase to avoid high physical or psychological pain, to avoid severe penalties or costs or to obtain/maintain competitive advantage. Deferment is not really an option, nor are there any substitute solutions.

B5. Sufficient, willing, funded, identifiable and reachable customers

A great number of businesses target 16-25 year olds, time poor executives, free thinkers or people with a desire to feel young at heart. The problem with this approach is that it is difficult to be proactive, to actually reach out and connect directly with the target customer. These businesses are highly dependent on passing traffic for business. It is far better to have a clearly identifiable target customer who you can directly and proactively approach. You need to offer something for which you know they have already expressed a need. For example, a product for registered dentists, members of a gym or subscribers to a journal are easily approached with an offer to purchase.

A clearly reachable, identifiable customer is one you can get in front of with your product or service message. Potential customers must be identified with a location where you can deliver your message. This also needs to be cost effective, thus a TV advertisement aimed at registered dentists does not make a lot of sense when a trade journal, a dental conference or a direct sales visit to a registered dental surgery would have a higher conversion rate.

An important attribute of the target market must be that they have the willingness and the ability to spend on the product or service. Furthermore, the business needs customers in sufficient numbers in order that the business can make enough revenue and profit to be a viable entity.

In a strategic sale, it will be the ability of the buyer to reach a customer base which will be critical to new revenue generation but the need to have a clearly defined customer is still important for the strategic buyer. The definition of the customer profile will often provide the key to the identification of the potential strategic buyers. The customer/market definition required in a strategic sale is that of the potential buyer. That is, which large corporations have a large customer base of the target customer and have the capability and capacity to sell the venture's products or services into their customer base.

Self-assessment

1. Numbers of customers, their defined attributes and locations and whether they are willing and able to buy have not been established.
2. Customer definition is reasonably clear but no attempt has been made to establish whether they can be approached proactively, are willing to purchase or are in sufficient numbers to make the venture attractive.
3. A clear definition of the customer exists, intention to purchase has been established but the size of the market has not been established nor has a program been developed to proactively reach them.
4. The size and location of a clearly defined existing and/or potential customer market has been established. The size of the market has been established and the level of buying intention has been estimated.
5. A clearly identifiable and reachable existing and/or potential customer market has been defined and validated. There is a clear intention to purchase the specific product of the firm and the size of the market would support the projected revenue of the venture.

B6. Obvious and meaningful competitive advantage

If you have a product or service in a marketplace which is simply littered with comparable offerings, you can have very little hope that your venture is going to be successful. If everything you do to be different can be readily copied with little effort, clearly you are in a business which has little chance of success. Only by finding a strong point of difference in an attribute that the target customers value will your own products or services carve out a segment of the market. The most desirable position to be in is to have a product which not only fully meets the needs of the target customers, but has no competitor or near substitute and has significant barriers to entry.

For a competitive advantage to be meaningful it needs to be validated by actual or potential customers. The difference must be meaningful and sufficiently important to the target customers that they have a clearly expressed preference for the product or service you are offering. Validation is also needed to ensure that a close alternative product is not available. A competitor analysis is necessary for you to validate your competitive advantage.

Self-assessment

1. A competitive analysis has not been undertaken.
2. The firm knows of a number of competitors but has not done any systematic analysis of their position relative to the competition.
3. A competitive analysis has been undertaken and shows the firm has some differentiation which should appeal to potential customers.
4. The firm has a clear competitive advantage in its target market and has validated this with potential customers who value the differential features.
5. The firm has outstanding differentiation which is highly valued by the target market or there are no obvious competitors and there are significant barriers to entry.

B7. Well protected sustainable attributes

While the firm may have established a competitive advantage with its product or service, this is really only beneficial if it can sustain and/or protect it over the long term. Sustainability can be achieved from registered intellectual property (IP) such as is the case of patents or copyrights. Protection may lie in the fact that the firm has certain rights which are exclusive or limited such as mining or forestry rights or a licence to practice. Expert knowledge, if hard to acquire, in limited supply or requiring extensive experience or training, may provide the basis for a sustainable advantage.

Protection can be legal rights which attach to patents or licences. Products and services can be protected by being difficult, expensive or time consuming to copy. A business may protect itself by controlling elements of the market such as preferred outlets, distribution channels or essential components. Other firms may be effectively locked out of a market through customer or supplier agreements or by controlling the source of an essential resource input. The ability to defend encroachment is an essential factor in maintaining protection. The firm which cannot defend a patent infringement, for example, has little protection against a large well-funded predator.

The value achieved in a strategic sale is directly related to the level of exploitation of the venture's products or services by the buyer. Therefore, the buyer is keenly interested in the level and sustainability of the competitive advantage which will be passed to them by the seller.

Self-assessment

1. The venture has not been able to establish any long-term protection for its products or services.
2. Products or services have short-term protection but this can be eroded by a determined competitor or anticipated new products in the market.
3. Products have some level of long-term protection but only through an aggressive product development process, strong customer service and/or features which appeal to a niche market.
4. The firm has strong intellectual property protection through patents, copyright or registration rights but these may be overcome or eroded by a determined and well-funded competitor although this would take some years to be effective.
5. The firm has very strong intellectual property protection through patents, strong branding, high customer loyalty or highly specialised and difficult to acquire knowledge. Significant funding and/or strong alliance partnerships are present to defend IP which can be expected to deter copying.

B8. Resources and channels to distribute are in place or able to be acquired

Great products or services which cannot be placed where customers can see them, try them or buy them are simply not going to generate revenue in any volume. A business which has an intention to grow, especially one wishing to grow aggressively, has to find channels to market which will put its products in front of the intended target customers in sufficient numbers for growth to be achieved. There are many possible channels to market and the business needs to choose those which are most appropriate for the type of product or service being offered as well as the type and purchase preferences of the target customer.

Some products suit direct sales or telemarketing and/or telesales, so capacity must be built within those channels. Can the business acquire, afford and train sufficient skilled numbers of staff to handle the intended volume? If the product suits a high volume distribution channel, can that be acquired or contracted at a price which is cost effective? Is the business able to utilise alliance partners or joint ventures to take the product to market? Many small firms lack the distribution reach to effectively scale their business and need to find partners to help them get to market. Is the business able to clearly show how the target volumes will be achieved through the chosen distribution channels and is it able to show that those channels are available, willing and affordable?

In the case of a strategic sale, it is the buyer who will provide the channels to market. The assessment of the venture potential will measure whether the product or service being developed can be readily rolled into the potential buyer's distribution channel. If it can, then the venture can easily satisfy this attribute.

Self-assessment

1. Distribution channels are not in place.
2. The firm is constrained by limited in-house distribution capabilities, lack of access to distribution partners and/or powerful distribution channels which control the interface to customers.
3. The firm has a well-defined distribution strategy but lacks an exclusive presence, incentives for distribution channels to put above average effort into the products or a lack of capacity to handle significant volumes.
4. The distribution strategy is well defined, is effective in reaching the target customers and can handle the volume of sales anticipated but lacks robustness to be able to adapt to disruptive events or shifts in channel commitment.
5. The distribution strategy is able to directly connect with the target market in an arrangement which provides the firm with excellent and timely exposure to the customer. The channels are highly motivated

and incentivised and have the depth and scope to cater for changed circumstances and can readily support the volumes required to meet financial objectives.

B9. Sales price and cost model provides robust achievable margins

The business needs to be able to validate both price to customer and expected costs of goods sold as well as fixed costs at each anticipated level of output. Prices might be established relative to competitors, perhaps supported by marketing survey data. Cost data may also have been established through competitor information or perhaps through a cost build-up model using quotations for external costs and cost allocation for internal costs. For established products, prices and costs should have already been validated through existing sales.

The business model will need to show that reasonable levels of profit can be achieved within a short period of time. Alternatively, a business which cannot move into reasonable profit must have a reliable source of continued subsidies to allow it to stay in business. The financial model should also be tested across a range of possible business conditions to see if the business concept is robust under worst, most likely and best case scenarios.

In the case of a strategic venture, the price and cost modelling must be sufficient to encourage the strategic buyer to go ahead with the deal. If the buyer can see a significant revenue opportunity with good margins and can readily justify the acquisition, this will make it easier for the firm to be sold.

Self-assessment

1. Sales price and costs have not been established.
2. Sales prices are estimated and costs have been partly established but neither validated.
3. Sufficient information on prices and costs has been ascertained to establish that the products can be sold for a profit. However, a sensitivity analysis has not been undertaken.

4. Prices and costs have been established and margins have been determined to be attractive. Volume sales show that profit targets can be reached, however, sensitivity analysis to cost variation or price variation has not been undertaken.
5. Sensitivity analysis has been undertaken across a range of possible price and cost scenarios and over worst, most likely and best cases and all scenarios produce acceptable levels of profit achievement.

B10. Integrated volume operations (development, manufacturing, logistics, support and infrastructure) are achievable

Many products or service businesses look great when the volumes are small. This is often because the founders take special care over the development and delivery of the customer solution and the customer is given additional assistance to ensure a satisfactory outcome. However, when the business grows, volume production requires a level of planning and control which is not required or needed when volumes or outputs are small. Logistics need to be much better integrated, quality needs to be controlled throughout the entire value chain and the business needs to have purchasing, human resources, marketing, administrative and IT infrastructure to support complex operations.

Businesses which can handle 10 or 100 transactions need to be massively redesigned when the volumes reach hundreds and thousands. How will the business cope if it needs to manage multiple locations? Does the business have the right people, structure and resources to build a larger, higher volume business?

Scalability and/or replication are critical to a strategic sale. The venture needs to be able to demonstrate that, in the hands of the buyer, significant volumes will be able to be produced with stability in quality and reliability in timing.

Self-assessment

1. Assessment of volume operations has not been undertaken.
2. An operations plan has been produced but a detailed operations plan has not been constructed to see if the plan is achievable.
3. The operations plan has been established at a low level of detail but supporting plans for staff recruitment, training and infrastructure have not been established.
4. A detailed operations plan has been compiled which fully supports the growth plans of the venture. Supporting detail shows infrastructure, staff and resource requirements, however, sensitivity analysis has not been undertaken in areas where delays, variations in productivity or shortages might occur.
5. A detailed, integrated, robust operational plan has been prepared which includes all support operations. The plan has been reviewed under various risk conditions and contingency plans have been developed to mitigate or negate likely risk situations.

B11. Management team is experienced, complete, committed, capable and entrepreneurial

Experienced investors know that business plans are very rarely implemented as written. Every plan is based on a number of assumptions and those often prove to be unfounded or are invalidated by economic, environmental and industry changes. The business may not develop in the manner in which it was originally planned. Experience tells the investor that the best solution to this problem is to have a proven management team which has the experience to cope with the changes that inevitably will occur. They look for an executive team which has the qualifications, experience, mix of skills and industry networks to implement the original plan but can also react to changing conditions and is still likely to achieve reasonable results.

In the case of a venture being prepared for a strategic sale, the management team, in conjunction with the Investor, must have the ability to undertake the sale preparation process. This may include completing product development,

establishing trial customers, building relationships with potential buyers and engaging professional advisors.

In the case of a financial venture, it takes more than industry knowledge and a capable management team to grow a business over time. Very few markets are stable over many years, being impacted by new inventions, new entrants and changing business models. Any business which grows over an extended period of time must have an entrepreneurial capability. This is the ability to see opportunities where others don't, an ability to construct different business models, a strong sense of timing about market changes, a willingness to have a go in the face of incomplete or ambiguous market data and the acceptance that some projects will fail.

Driving a business forward in the face of changing conditions also requires leadership and good judgement. A strong vision, a sense of partnership and involvement and a sense of personal achievement and growth are all characteristics of a positive work culture. A business grows over time, not by doing the same thing all the time, but by evolving to take advantages of opportunities in the market place. A business which is open to new ideas, willing to try new approaches to doing business and encourages people to try small experiments will proactively generate avenues for growth.

Whether the intended exit is financial or strategic, Investors know that they work in start-up and early stage ventures where the passion, drive and energy of the entrepreneur and the management team are critical to success. A good product or service, by itself, will not be sufficient to provide the traction necessary to drive the business to success. The Investor needs to see indications of what the team members have achieved individually and collectively; that they have the ability to take initiative, be proactive and creative and have the determination to succeed in this venture. The Investor also wants to see that the executives are committed to the venture. This may occur through their own personal financial investment, time invested in the venture or the fact that they have put their personal reputations behind the business. Where there are missing skills, the investor wants to see these are acknowledged and a proposal put forward to recruit the necessary talent.

Self-assessment

1. Assessment of the current management team has not been undertaken or no team has yet been assembled.
2. The current management team lacks some key skills, experience and knowledge and plans are not yet in place to recruit to fill the gaps. The current team has not acknowledged any deficiencies which need to be filled. It is not obvious whether the team will stay with the venture if the going gets tough. The team has not demonstrated entrepreneurial activity.
3. The current management team is highly competent in most of the key areas and has the skills and experience to take the venture forward. Key gaps have been identified but a plan has not been developed to fill the gaps. Some members of the team have made personal financial or time commitments. Individuals within the team have shown entrepreneurial activity but they have yet to demonstrate this as a team.
4. The management team has the experience, capability and knowledge to take the venture forward and have plans in progress to recruit some key individuals as part of the growth planned. Succession plans have not been developed. The team has made significant financial, time and/or reputation commitments to the venture. The team demonstrates an entrepreneurial capability.
5. The management team is experienced, has the necessary range of skills, experience and entrepreneurial capability to grow the venture and has an organisational plan for both growth and succession. It is clear that the team is very committed to the venture and will put in the time and effort even if the venture proves to be more difficult than expected.

B12. Financial projections show robust acceptable ROI

The business concept should to be tested across multiple scenarios to ensure that a reasonable financial return can be achieved even in the most unlikely circumstances. When possible funding is added to the financial forecasts, the forecasts should show that the Investor is able to achieve very good results. Robust financial forecasts should declare and test the validity of the basic assumptions. By changing basic assumptions to different possible situations,

the model can be tested for robustness. Those assumptions which have the greatest sensitivity can then be addressed with counter measures or additional activities to minimise their impact.

Within the period of the investment where survival and operational performance are critical, financial projections should include income statements, balance sheets and cash flows. A breakeven analysis should be shown. These various financial projections should be created under several possible scenarios including worst case, best case and most likely case.

Estimates of exit values should be undertaken to show that the business is able to achieve the rates of return desired by the Investor under all possible exit scenarios. Remember that in the case of a strategic exit, revenue and profit growth may not be relevant. What is important is to produce something which the strategic buyer wants.

Self-assessment

1. Financial projections have not been prepared.
2. Financial projections have been prepared but are at a high level of aggregation and are based on assumptions which have not been validated. Detailed cash flows are not available.
3. Detailed financial projections have been prepared which show acceptable levels of profits (if relevant) and ROI but some assumptions are questionable and a scenario analysis has not been undertaken. Detailed cash flows are available.
4. Detailed financial projections have been made which show acceptable levels of profit and revenue growth (if relevant) and ROI. Underlying assumptions have been validated and are acceptable. Scenario analysis has not been undertaken.
5. Detailed financial projections with worst case, most likely case and best case have been undertaken. Underlying assumptions have been validated. Projections have been validated by an independent professional advisor. Profit and ROI targets are robust and achievable under all scenarios.

B13. Risk analysis shows resilience to possible delays, shortages, competitive retaliation, quality issues, failure to recruit the right staff, etc.

Most simulations of financial projections concentrate on changes in revenue levels but fail to take into account other risks which may be equally damaging to the venture. The Investor needs to isolate those factors within the business which can have the most disruptive impact on desired targets. It is only by undertaking such an analysis that the Investor can uncover the likely risks which can severely impact target achievement.

Once a risk assessment has been undertaken, those risks can be subjected to their own mitigation planning exercise. A business plan which anticipates potential problems can build contingency plans and take steps to avoid, mitigate or reduce the impact of possible negative events. Risk analysis may result in strategies being developed which change the order of introduction of products, the timing of selected capital expenditures or planned targets.

Self-assessment

1. Risk assessment has not been undertaken.
2. Some major risks have been identified but a plan has not been developed to deal with these when they occur.
3. Major risks have been identified and plans have been developed to deal with them when they occur, but mitigation or avoidance plans have not been implemented.
4. A risk analysis across the enterprise has been undertaken and plans have been put in place to counter, mitigate or avoid them.
5. The business strategy has been developed and implemented to take into account those risks which would have a damaging effect on the business achieving its objectives.

B14. A robust and well-articulated exit strategy has been defined

Investors need to see a path to liquidity for their investment. Few Angel or VC investors invest for dividends; most will be investing for capital gains. However, whether they invest for dividends or capital gains, they still need to have a mechanism for releasing their original investment. The normal form of harvesting is either a sale to another business (trade sale) or a listing on a public stock exchange (an initial public offering or IPO). Many investment proposals use such exit phrases as 'sell to a corporation in 3-5 years' or 'list on the stock exchange in five years' with no substance behind the statement. They have neither identified who the potential buyer might be nor how they would be an ideal candidate for an IPO.

The business proposal needs to demonstrate to the Investor a well-articulated exit strategy which is meaningful. A trade sale strategy should have identified potential buyers and have convincing arguments as to why the selected corporations should buy the business. An IPO strategy should show how similar businesses, with comparable products, services and growth patterns, were able to list on the target exchange.

Self-assessment

1. An exit strategy has not been identified.
2. The exit strategy is very general and lacks detail or validation.
3. A possible exit strategy has been articulated which looks feasible but lacks detail and resilience.
4. The exit strategy is very detailed, seems highly probable and includes estimates of timing, resources required and costs for professional services.
5. Professional advice has been received to validate the exit strategy and adjustments have been made as a result. The exit strategy is highly probable and resilient. Alternative exits are capable of being executed depending on market circumstances.

Venture Potential Index

Nothing done	Little progress	Reasonable progress	Significant progress	Fully attained	N.A		
1	2	3	4	5			
Item	Attribute	1	2	3	4	5	N.A
B1	Business and economic conditions support the venture						
B2	Well articulated, focused vision of the purpose of the venture						
B3	Innovative product, process or business concept						
B4	Clear and compelling customer need						
B5	Sufficient, willing, funded, identifiable and reachable customers						
B6	Obvious and meaningful competitive advantage						
B7	Well protected sustainable attributes						
B8	Resources and channels to distribute are in place or are able to be acquired						
B9	Sales price and cost model provides robust achievable margins						
B10	Integrated volume operations(development, manufacturing, logistics, support and infrastructure) are achievable						
B11	Management team is experienced, complete, committed, capable and entrepreneurial						
B12	Financial projections show robust acceptable ROI						
B13	Risk analysis shows resilience to possible delays, shortages, competitive retaliation, quality issues, failure to recruit the right staff, etc.						
B14	A robust and well articulated exit strategy has been defined						

Operations Development

The Operations Development Index (ODI) has been designed so that an Investor can measure the quality of governance and operations management within the investee firm. It can be used to evaluate the potential investment as well as provide a tool for measuring the progress of development of internal systems once the investment has been made.

A business can only be run effectively if it has the measurement and reporting systems in place to set targets and review performance. The use of KPIs, budgets and proper reporting systems are critical. Governance issues deal with compliance and risk management and can be seen in good relationships with customers, suppliers, bankers and so on. Operational excellence should be an objective of the Angel as this can positively contribute to the value of the business at the time of sale or as preparation for an IPO.

As part of the initial due diligence of the firm, the ODI can help the Investor assess potential risks in the investment. When an Angel or VC investor enters into an investment, they are exposed to the trading risks of the investee company. They are also exposed to any current or contingent liabilities, current and potential employee disputes, customer issues and supplier disputes. Once the investment has been made, these risks will be managed through management oversight and restrictions on how monies can be used and what loans can be incurred.

The Investor will also have arrangements in place where they can more actively intervene and sometimes take complete control if the business fails to perform to agreed schedules and targets. However, this is little comfort to an Investor who is reliant on the management team to operate the business. Pre-existing conditions may be underwritten somewhat through warranties and representations and failure of the business to perform may be somewhat compensated for by a share dilution formula which adjusts the Investor's percentage of ownership, but this is little comfort to the Angel or VC firm which has invested in a lemon.

The Investor needs to establish the level of risks associated with the investment before they do the deal, not after. So an extensive investigation will often be undertaken to uncover any skeletons which may lie in wait for the unwary investor. Depending on the size and complexity of the firm, this process can take many months and be very expensive. While this cost is usually absorbed by the Investor, it is almost certainly factored into the valuation or use of the investment funds. In some cases it may be underwritten or reimbursed by the investee company.

The Investor will be trying to estimate the costs and time needed to be devoted by the Investor, executives within the firm and external advisors to bring the investee company up to the quality needed for an ongoing stress-free operation. As items are uncovered, the Investor will need to estimate the time and cost that will be incurred to resolve the issue. Of course, some may not be that simple, cheap or quick to resolve. Other items may be serious and there may not be an easy way to estimate the likely damage or cost to resolve. This is particularly true with contingent liabilities, intellectual property ownership doubts and unclear customer obligations which have not been fulfilled.

At some point, the Investor may simply decide that the level of risk is too high to proceed, or they might decide that it will take too long and be too expensive to establish the level of exposure in the outstanding issues.

Clearly a firm which appreciates the concerns of the Investor and has closely managed its operations, managed its risk exposure and ensured that it has fully complied with industry regulations, is a good candidate for Angel or VC investment.

The ultimate due diligence test which could be used by an Investor is the following:

Can I leave the investee firm alone to continue managing its operations without incurring any unreasonable level of risk?

Can I achieve my required ROI in the investment by devoting my effort to where I can add the most value without being distracted with having to clean up problems first?

Not all issues will be resolved by the firm in advance of an Investment, but the more the firm can do prior to the investment, the easier it is for the Investor to complete the due diligence investigation and move to consummate the investment arrangements. A firm which is prepared for due diligence is a major advantage for an Investor.

The initial investigation can provide the Investor with a checklist to be used after the investment to drive improvement in the governance and operations management of the firm. An Investor keen to see a trade sale or an IPO within a few years of his investment should be sensitive to the positive impact a clean bill of health on the ODI will have on the potential exit value of the firm.

In a trade sale situation where the potential buyer is a corporation, aspects of the acquirer's due diligence will deal with the actual integration of the two companies. This will involve reviewing the costs, problems and delays of merging the acquired business into their own organisation and will involve such things as personnel systems, benefit systems, IT infrastructure and so on. The only way the firm can prepare for this possibility is to ensure that they use industry standard processes wherever possible.

C1. Monthly financial and key performance indicator reporting exists

The existence of a comprehensive reporting system is important for several reasons. These are:

- It demonstrates that the firm is well run.
- It shows that the management is effective.
- It shows attention to detail.
- It demonstrates that an underlying infrastructure is in place.
- If comprehensive, it should show that problems are identified early and addressed.

The financial reporting systems should produce balance sheet and income statements, cash flow projections, aged debtors and aged creditor reports.

More sophisticated systems go beyond monthly financial reporting. Every business has key performance indicators (KPIs) which demonstrate health and competitive alertness. Reporting systems should be able to demonstrate that the company is operating efficiently in all major areas of operations. For example, in sales, reporting systems might examine tenders received, tenders sent, contracts under review, contracts received and revenue to estimates. In production, it might refer to actual production versus planned production, overtime hours worked, rework hours, inventory levels and so on.

In a due diligence investigation, the Investor will be attempting to estimate the level of intervention that is to be put in after the investment. To the extent that good management systems are in place, this should considerably reduce the Investor's concerns.

Self-assessment

1. Internal reporting systems are unsophisticated and incomplete.
2. Monthly financial reporting exists but is not comprehensive.
3. Monthly reporting exists but few KPIs are tracked.
4. Monthly reporting systems and KPIs are tracked but have not been audited for completeness and effectiveness.

5. Comprehensive monthly financial and KPI reporting exists. Professional advice has been taken to ensure completeness and effectiveness.

C2. A formal business plan has been prepared and is updated periodically

Most business people would agree that business plans are outdated as soon as they are printed. However, the discipline of preparing the business plan captures the holistic nature of the enterprise. This is one of the few times where management have the opportunity of rethinking the vision, goals and strategy of the firm. It is by pulling it all together that they will gain insights into areas of weakness and opportunities where the business can be improved.

For the Investor, a good business plan provides insights into the business. For example:

What is the vision and how is this translated into strategy?

What are the competitive assets and competencies of the firm and how are these being leveraged into competitive advantage?

Which markets do they compete in and how are they placed?

What are the assumptions behind the numbers and have these been validated?

What risks are present in the business and how are these being addressed?

What is the worst case scenario?

Do they understand their underlying cost and revenue structures and has this been translated into a breakeven analysis and a breakdown of recurring and new business?

Can they demonstrate clearly where the business comes from and why?

Do they have clearly articulated marketing and sales plans with identified targets?

Has business growth been translated into a headcount plan and a funding plan?

The business plan demonstrates that the management team understand what it takes to be successful. It should be more than a spreadsheet, it is an explanation of why the business is successful and should be backed up with validation of assumptions.

The question that should be asked by the Investor is:

Can this business be run successfully without me having to intervene to make it work?

It may not be the Investor's intention to leave the business the way it is, after all, part of the reason for selecting a specific investment is to leverage the Investor's knowledge and contacts. However, he should be trying to estimate the level of effort he is going to have to put in to improve their operations management. If the business can be left alone to run itself for some period of time, the Investor can concentrate on future plans for the business without having to shore up normal operations.

The business plan may also indicate where additional potential lies for the firm. This helps the Investor to evaluate the opportunity and perhaps see how the opportunity may be developed with additional resources or assistance from the Investor.

Self-assessment

1. A business plan does not exist.
2. There is a business plan but it is out-of-date and/or incomplete.

3. There is a comprehensive business plan but it simply projects past trends and is not a strategy document.
4. A comprehensive business plan exists and is up-to-date but does not have the depth or validation needed to provide a good explanation of strategy or how the business might perform in the longer term.
5. A very comprehensive business plan exists which is of professional quality and fully explains the business strategy, the capabilities and the likely outcome of the business in the longer term.

C3. A formal budget is prepared and actual performance is monitored against budget

The preparation of formal budgets (profit & loss, cash flow and balance sheet) serves a number of purposes including:

- quantification of formal business plan.
- identification of projected profit and loss and cash flow.
- a basis for financial discussions with external parties such as debt and equity provider.
- a basis for monitoring the actual performance of the business against the business forecast.
- a basis for performance evaluation of key staff and departments.

The budget should provide the basis for monitoring actual performance against budget and should link the formal business plan to the actual performance of the business.

Budgets should be prepared and monitored on a monthly basis. Budgets should be prepared on a geographic and department basis in order to properly assign responsibility and facilitate the management of variances.

Preparation of a formal budget and analysis of actual performance against budgeted performance should provide the following benefits to the business:

- assist in identifying under or over performance against budget
- enable timely actions to be taken where actual performance is

significantly different to forecast performance

- ensure key financial information is monitored at various levels throughout the business
- promote accountability of key individuals and departments.

Evidence of regular budget to actual analysis by the business will provide the Investor with greater comfort that the business has been actively monitored and proactively managed and that business risks are being assessed on a regular basis.

Self-assessment

1. A budget is not prepared and analysis of actual results to budgeted results is not performed
2. There is a budget, but it is out-of-date, or not regularly monitored.
3. There is a summary budget, but it is not detailed enough, does not link to the business plan, does not ensure accountability of key staff/ departments and is not regularly monitored.
4. A budget exists which partly assists in monitoring actual to forecasts of the business (including accountability of key staff/departments).
5. A comprehensive budget exists which supports the formal business plan and is a major tool in the ongoing monitoring and assessment of business performance including monitoring accountability of key staff/ departments.

C4. Full compliance with regulatory issues (e.g. environmental, health and safety)

The Investor will be investigating the health of the business in terms of the quality of its underlying systems. These will include all the compliance areas. These will vary from industry to industry but may include:

- tax reporting (income, payroll and sales tax (BAS, VAT, GST, etc))
- company financial reporting
- corporate governance (shareholder tracking, board minutes, etc)

- employment law reporting
- mandatory insurance
- health and safety practices and accident reporting
- environmental compliance
- industry-specific regulations.

These areas are critical in a review as they can point to weak management, lack of concern for potential exposure and the possibility of litigation and penalties. The exposure may not only be for ongoing practice, but may be retrospective in more severe cases such as environmental issues.

Self-assessment

1. Compliance is not treated seriously and is inconsistently implemented.
2. The firm is concerned about compliance and has some systems in place but a comprehensive program does not exist to ensure compliance or to ensure completeness of coverage.
3. Compliance is treated seriously but is left up to individual managers and there is no system in place to ensure that all areas are covered and full compliance is occurring.
4. A full list of compliance issues exists, responsibilities are defined and some areas have reporting systems to ensure that compliance is being adhered to. Professional advice is being sought to undertake an audit in order to put a comprehensive reporting system in place.
5. Compliance reporting is comprehensive and effective and is audited by professional advisors on a periodic basis to ensure completeness and effectiveness. No outstanding or anticipated litigation exists.

C5. Customer relationships are managed to minimize litigation

Litigation and potential litigation occur when aspects of the business are not conducted fairly, transparently and according to accepted standards of good conduct. It is not sufficient to hope that external and internal relations are managed well. The Investor will examine whether the firm has policies, procedures and systems in place to ensure that they are doing so.

In the case of customers, the firm needs to conduct its business so that customers clearly understand the obligations of the firm, customer expectations are clearly understood and performance to documented and implied contractual conditions is monitored. Products and services need to be fit for purpose, of merchantable quality and sold with clear explanations of intended use. The firm should be prepared to assist customers to ensure that effective intended use can be readily achieved. Failure to understand the customer's needs and intended use exposes the firm to potential complaints, wasted resources and possible litigation.

The firm should have in place fair and reasonable contracts or agreements with customers, effective complaints handling processes and monitoring systems to ensure obligations are met.

Investors will be concerned about potential risks. Poor customer handling and poor internal processes suggest exposure to potential litigation, workplace unrest and/or loss of customer respect and retention. These seriously damage the company as a place to work or do business, potentially threatening the viability of the business. The Investor does not want to inherit problems which may distract from achieving the objectives in the investment. A firm with underlying potential litigation can severely disrupt the firm and will probably exclude it from a successful trade sale or IPO. The Investor may be better off to walk away from the investment than to take the risk.

Self-assessment

1. Special effort is not taken by the company to avoid litigation in external customer relationships. Accounts are not reviewed for current or potential problems on any systematic basis. An escalation process does not exist to deal with unresolved issues.

2. The firm acknowledges that it can do better. Staff have been advised of the implications of unresolved customer issues. A complaints system is in place.
3. A formal customer complaints system is in place with proper escalation procedures. Formal agreements exist with customers which deal with outstanding problems.
4. Professional advice has been taken on establishing formal systems of dispute resolution, complaints handling and problem escalation. Contracts have been reviewed by professional advisors. Relationship management training has been given to staff where appropriate.
5. Formal review systems are in place for all agreements with customers. The firm is proactive in dealing with customers to ensure that expectations are set correctly and are monitored on an ongoing basis. Formal complaint handling systems and dispute resolutions systems are in place with staff trained and advisors available. Professional advisors review any serious disputes and provide advice on problem resolution.

C6. Supplier relationships are managed to minimize litigation

Good supplier management is essential for the efficient operations of a business. Litigation and potential litigation occur when aspects of the business are not conducted fairly, transparently and according to accepted standards of good conduct. It is not sufficient to hope that external and internal relations are managed well. The Investor will verify that the firm has policies, procedures and systems in place to ensure that they are doing so.

Some suppliers are more critical than others where they supply essential parts, where there are no effective substitutes or the switching costs of moving to another supplier is high. Managing supplier relationships is essential for the health and ongoing effective operation of the business. The firm should have fair and equitable agreements with suppliers and these should be industry standard wherever possible. Supplier relationships should be managed by people in the company who understand that relationships are more than simply placing purchase orders and negotiating the best price.

The firm needs to be able to demonstrate to the investor that goodwill exists in those relationships, the business values their suppliers and issues and complaints are dealt with in a timely and reasonable manner.

Investors are always concerned about potential risks and disruption. Poor supplier relationship management and poor internal processes to resolve problems suggest exposure to potential litigation, workplace unrest and/or potential loss of key suppliers. Failure to monitor payables and resolve disputes may also affect credit rating. No Investor likes to inherit problems which may distract them from achieving the potential in the investment. An investment in a firm with underlying potential litigation can severely disrupt both the firm as well as the Investor who may have to become involved to resolve the situation.

Self-assessment

1. Special effort is not taken by the company to avoid litigation in supplier relationships. Accounts are not reviewed for current or potential problems on any systematic basis. An escalation process does not exist to deal with unresolved issues.
2. The firm acknowledges that it can do better. Staff have been advised of the implications of unresolved issues. A complaints system is in place.
3. A formal complaints system is in place with proper escalation procedures. Formal agreements exist with suppliers to deal with outstanding unmet obligations and disputes.
4. Professional advice has been taken to establish formal systems of dispute resolution, complaints handling and problem escalation. Contracts have been reviewed by professional advisors. Relationship management training has been given to staff where appropriate.
5. Formal review systems are in place for all agreements with suppliers. The firm is proactive in dealing with suppliers to ensure that expectations are set correctly and monitored on an on-going basis. Formal complaint handling systems and dispute resolution systems are in place with trained staff and advisors available. Professional advisors review any serious dispute and provide advice on problem resolution.

C7. Employee relationships are managed to minimize litigation

The Investor will want to know that good management practice systems and fair and reasonable workplace conditions are in place for effective employee management. Employees should understand clearly what is expected of them, be provided with opportunities to provide feedback on their experience and be given performance appraisals to ensure they understand how they are meeting expectations. Processes should be in place to deal with harassment and discrimination in the workplace. Only through effective and systematic performance monitoring and corrective action can the firm adequately deal with dismissals without creating situations which might lead to unfair dismissal claims and possible litigation.

Every business is dependent on its employee's goodwill and motivation. If the workplace conditions are not fair and reasonable at a minimum and if justice is not done and seen to be done, this creates a poor working environment. It is inevitable that the firm will go through a series of changes of management, systems and direction after the investment. This is going to take a lot of goodwill and support from existing staff. An Investor doesn't wish to start off this process at a disadvantage. In addition, poor performance management processes expose the company to claims for unfair dismissal or discrimination. No Investor wants to be exposed to potential unquantifiable future litigation costs and damages. Contingency liabilities are normally the death of a future trade sale or IPO.

Self-assessment

1. Special effort not is taken by the company to avoid litigation in employee relationships. Workplace issues are left to local supervisors and local management to resolve. There are no full-time or dedicated employees responsible for compliance or to assist in resolving workplace relationship issues. A systematic process does not exist to set and evaluate performance.
2. The firm acknowledges the need to introduce more formal processes. Job descriptions are in place for most of the employees and an evaluation process is used for performance review and setting pay increases.

3. Performance targets and formal reviews of achievement are in place. A member of management is responsible for compliance. Management has been briefed on workplace issues of harassment, discrimination and performance review documentation and dismissal processes. However, these are not systematically followed.
4. Formal processes exist for defining job descriptions, setting and assessing performance targets and dealing with employee workplace issues. Management has been trained on all aspects of compliance and workplace performance and dismissal processes. No external professional advice has been sought to audit the quality of the processes.
5. Systems and procedures are fully documented and audited to ensure full compliance with best practice in performance reviews, dismissal handling and workplace incident handling. The company has professional internal staff and/or external advisors to assist with any serious incident.

C8. Credit worthiness with suppliers is excellent

The quality of external relationships is often an indicator of the quality and integrity of the management team and the culture of the firm. As the business grows some level of disruption to the business is likely to occur. During this period the goodwill of suppliers is going to be necessary so that additional problems don't create crisis events. By reviewing credit payment performance information and interviewing suppliers, the Investor can obtain a measure of the way in which management has dealt with issues in the past.

Few companies are able to avoid fluctuations in their cash flow. However, problems can often be mitigated by good relationships with suppliers. Suppliers who are normally paid promptly and dealt with fairly are often willing to extend additional credit for short periods during difficult times. This is especially true if the firm has dealt with them honestly and shown past behaviour of bringing situations back to prompt payment.

Those firms which keep their suppliers informed, proactively tell them about impending issues and show good management skills in correcting problems

promptly, are much more likely to be given extended credit to cover short-term situations. A review of supplier credit performance will help the Investor gain an independent measure of the quality of management and their culture and values.

Self-assessment

1. The firm deals with suppliers at arms length and makes no special effort to value their relationship. The firm makes no special effort to keep in regular touch with them or to keep them abreast of business issues.
2. The firm is sensitive to dealing with suppliers and pays when possible on agreed terms. However, suppliers are only contacted when payments are already late.
3. The firm has processes for reviewing credit with suppliers and keeps them informed of any issues where extended payment may be taken. The firm has a member of management who meets with them on an informal basis when the occasion arises.
4. The firm actively informs suppliers of account status and will pay early if cash permits. Suppliers are kept informed of the level of likely business which will be placed with them. When payments have been delayed, senior management will personally contact the supplier to review the situation.
5. Professional advice has been sought on credit worthiness best practice and systems implemented. Senior management keeps suppliers informed of any payment issues well in advance and before payments are overdue.

C9. Banking relationships are excellent

The quality of a firm's relationship with their bank is a very good indicator of the way in which they conduct most of their business. External relationships are often an indicator of the quality and integrity of the management team and the culture of the firm. With any significant business development, which can be expected after an injection of capital, some level of disruption to business is likely to occur. During this period the goodwill of suppliers, customers and bankers is going to be necessary so that additional problems don't create crisis

events. By reviewing formal and informal contact with the bank, the Investor can determine the manner in which management has dealt with issues in the past.

Few companies are able to avoid some fluctuation in their cash flow. However, problems can often be mitigated by good relationships with suppliers and by working closely and honestly with the bank. Those firms which keep their bank informed, proactively tell them about impending issues and show good management skills in correcting problems promptly, are much more likely to be extended a line of credit or a loan from the bank to deal with short-term fluctuations. By examining how the firm has dealt with issues in the past, the Investor can gain an independent measure of the quality of management and of their culture and values.

Self-assessment

1. The firm deals with its bank at arms length and makes no special effort to value the relationship. The bank is simply treated as a facility and the firm makes no special effort to keep in regular touch with the bank or to keep it abreast of business issues.
2. The firm is sensitive to dealing with its bank, however, the bank is only approached when a need arises.
3. The firm has processes for reviewing its pattern of business with its bank and keeps it informed of any issues where cash flow might be seriously affected. The firm has a relationship with a named bank officer and meets with them on an informal basis when the occasion arises.
4. Informal arrangements are in place with the bank to review business performance and banking requirements. The firm also has periodic formal meetings with the bank to review their banking arrangements and banking facilities.
5. The firm has established formal meetings with the bank on a regular basis where current and future banking requirements are reviewed. Senior management of the firm are known to the bank and informal social relationships are encouraged by the firm.

C10. Customer interaction, contracts and agreements are industry standard

A firm incurs problems and costs when obligations under contracts are unclear, incomplete, harsh or generous. Risks escalate when procedures for handling disputes, complaints, claims or clarification are not clear or not followed. When customers can make claims on the company which cannot be substantiated internally, where the obligations are not clearly set out and where the terms of payments are unclear, the firm can be exposed to potential litigation, loss of resources or significant under payments.

A situation in which contracts can be customized to suit the customer becomes an administrative burden. Few firms have the processes in place to track individual contracts where obligations and terms vary from one contract to another and so the likelihood of making a mistake in this situation is very high. Problems can be greatly exacerbated if contracts are voluminous or held at a place away from where activity is being undertaken.

Investors want to see a smooth administrative operation. If the contracts are not standard or vary from contract to contract, costs increase. Risks may occur if personal undocumented knowledge is required to manage the relationship. If the person with that intimate knowledge leaves, so does the ability to handle issues which arise.

Policies for dealing with customers should be clearly set out and staff trained in the various activities which require interaction with customers. Errors are easily made where inconsistencies in processes are allowed to occur.

Self-assessment

1. Interaction, contracts and agreements with customers are informal and vary in approach, terms and conditions.
2. Staff are advised on how to deal with customers but this is not formally supervised or reviewed. Contracts and agreements with customers are mostly written but variations exist and these are not well documented. Formal sign off of customer contracts is not in place where complex projects are undertaken.

3. Staff are trained to deal with customer issues. The firm has policies in place for most customer interaction but these are out-of-date and compliance is not reviewed formally. Formal contracts and agreements are used with customers but variations are common. Variations are well documented and agreed by both parties. Formal progress monitoring is in place and sign off occurs at key stages in projects.
4. Formal policies are in place for interaction with customers and staff are trained on these. Compliance is monitored and issues dealt with promptly. Standard contracts and agreements are in place with customers and progress on long-term projects is monitored. However, steps have not been taken to ensure that contracts are industry standard and best practice for monitoring are in place.
5. Professional advice has been taken and recommendations implemented to ensure that contracts with customers are industry standard and that progress monitoring and sign off procedures are in place and being followed. Periodic audit of customer contracts and progress tracking are in place. Formal policies for dealing with customers are in force and are regularly monitored.

C11. Supplier contracts and agreements are industry standard

A firm incurs problems and costs when obligations under supplier contracts are unclear, incomplete, harsh, or generous. Risks escalate when procedures for handling disputes, complaints, claims or clarification are not clear or not followed. When suppliers can make claims on the company which cannot be substantiated internally, where obligations or the terms of payments are unclear, the firm can be exposed to potential litigation, loss of resources or significant over payment.

A situation in which contracts can be customized for each supplier becomes an administrative burden. Few firms have the processes in place to track individual contracts where obligations and terms vary from one contract to another and the likelihood of making a mistake is very high. This situation is exacerbated if contracts are voluminous or held at a place away from where activity is being undertaken.

Investors are looking for efficient administrative operations. If the contracts are not standard or vary from contract to contract, smooth operations are not possible. Further risks may occur if personal undocumented knowledge is required to manage the relationship. If the person with that intimate knowledge leaves, so does the ability to handle issues which arise.

Self-assessment

1. Interaction, contracts and agreements with suppliers are informal and vary in approach, terms and conditions.
2. Staff are advised on how to deal with suppliers but this is not formally supervised or reviewed. Contracts and agreements with suppliers are mostly written but variations exist and these are not well documented. Formal sign off of supplier contracts is not undertaken where complex projects are undertaken.
3. Staff are trained to deal with supplier delays, missing or incomplete orders, quality issues and relationship problems. The firm has policies in place for most supplier interaction situations but these are out-of-date and compliance is not reviewed formally. Formal contracts and agreements are used with suppliers but variations are common. Variations are well documented and agreed by both parties. Formal progress monitoring is in place and sign off occurs at key stages in projects.
4. Formal policies are in place for interaction with suppliers and staff are trained on these. Compliance is monitored and issues dealt with promptly. Standard contracts and agreements are in place with suppliers and progress on long-term projects is monitored. However, steps have not been taken to ensure that contracts are industry standard and best practices for monitoring are in place.
5. Professional advice has been taken and recommendations implemented to ensure that contracts with suppliers are industry standard and that progress monitoring and sign off procedures are in place and being followed. Periodic audit of supplier contracts and progress tracking are in place. Formal policies for dealing with suppliers are in force and are regularly monitored.

C12. Contracts can be assigned to an acquirer

Companies which are expected to be sold must have the ability to assign the rights under their contracts, licenses and agreements to the new buyer. Agreements which do not allow this inhibit the ability of the new owner to operate the business. Some agreements have clauses which allow assignment only with the permission of the other party. This agreement should be obtained prior to going into an acquisition discussion.

Many agreements do not allow for assignment to a competitor. This is not an unreasonable condition if such a change could potentially harm their business. In this case, the firm needs to have a contingency plan to be able to replace that part of their business if it is critical to their operation. Where such an agreement might stop the acquisition from happening, the best action is to terminate the agreement and replace it prior to preparing to sell.

Self-assessment

1. The firm is not aware of this requirement and does not know what the status of its various agreements are in this regard.
2. The firm acknowledges that this would be desirable but has not reviewed the contracts for compliance.
3. Contracts have been reviewed and those which do not allow assignment have been identified and responsibility given to an executive to renegotiate this condition.
4. Contracts have been renegotiated (where possible). The firm does not see any situation which would inhibit an acquisition. Contracts have not been reviewed by professional advisors.
5. Contracts, licences and agreements have been reviewed by professional advisors and no critical impediment remains to assignment of rights.

C13. Intellectual Property is able to be traded and is appropriately protected

Intellectual property (IP) covers those knowledge assets of the company which can be sold independent of the people who created that knowledge. Knowledge in the heads of employees which is not documented cannot be sold without the employees who have it. Documented knowledge, where the ownership may be in dispute or where ownership is unclear, cannot be effectively traded. Other IP rights which are purchased and are critical to the operation of products or services, need to be able to be sold or assigned to a new owner. Any contractual impediments to the use of internal or purchased IP will seriously inhibit a firm's ability to exploit the IP and may seriously damage the potential of a sale of the business.

Many acquisitions are targeted at acquiring competitive advantage through the acquisition of firms which hold patent rights. Patents which have considerable revenue generating potential can attract litigation over ownership rights if this has not been carefully managed from the outset of a research and development project as any employee who has worked on the project could potentially claim an ownership share. The only way for the firm to protect itself from such a claim is to have employees assign all rights of any inventions, or those relevant to their workplace, to the firm. Alternatively, rights could be assigned to the firm with acknowledgement of an ownership share, this leaves the firm in a position to have full rights to exploit the patent subject to a royalty based on an agreed formula.

Another aspect of IP is that the firm must ensure the IP was adequately managed throughout the development process. IP management must ensure that IP does not infringe any other IP rights, that the IP is appropriately registered and that rights are kept current. Since many IP rights require registration in other countries, the firm needs to have documentation of the extent of the registered rights and be able to show how these may be further protected in any future acquisition negotiation.

Self-assessment

1. An IP management program does not exist.
2. The firm acknowledges the importance of IP management but has no formal system to register or protect it.
3. IP management is considered important and the firm has registered various IP but the ownership trail is incomplete and may be subject to dispute by current and/or past employees.
4. Formal IP management processes are in place. Rights are registered in countries deemed appropriate for the business. Employees are required to sign over IP rights as a condition of their employment. IP acquired externally and used in the business will be able to be traded by a new owner.
5. The firm has undertaken an audit by a professional advisor and implemented systems and procedures recommendations to ensure full protection of its IP rights.

C14. Post acquisition changes in employment are planned for

Detailed consideration of the organisation structure following a possible future acquisition will indicate which roles will need to change and which roles will be redundant. Rather than leave this issue for the new owner to resolve, the firm can negotiate potential changes with those employees who are likely to be affected and put in place agreements which will smooth the transition.

A future buyer will almost certainly be confronted with the need to make organisational changes. These will involve changes of management, redundancies, roles and reporting lines. Many of these changes could potentially effect compensation packages. Effecting these changes and avoiding unrest, disruption and de-motivation will be challenging. The potential for litigation is present where current conditions of employment are at odds with the new situation. An employee who feels he or she has been misled or feels constructively dismissed through the changes, may feel compelled to seek legal advice.

Managing expectations, providing acceptable options for employees who are effected and preparing staff for the likely change, is all part of preparing to sell the business. Some employees may decide to take early retirement or seek alternative employment. Others may see the change as beneficial and want to stay on. Key employees need to be retained and need to be handled carefully so that there are incentives for them to stay during a transition period. Others may need to be given incentives to leave where their roles are being changed significantly or where they are being made redundant.

In anticipation that the business will be sold in the future as part of the strategy agreed with the Investor, the firm should put in place employment conditions which will ease the path to sale and transition across to a new owner. For example, current terms and conditions of employment may include the option for the business to make the employee redundant on transfer of ownership and state the level of compensation to be paid. Alternatively, a retention bonus may be specified for key employees to encourage them to stay. Benefits may be able to be changed on sale of the business.

Self-assessment

1. Attempts have not been made by the firm to implement changes in employment conditions to facilitate the future sale of the business. Discussions have not been had with employees about post acquisition roles.
2. The firm has reviewed its organisation structure and determined those positions which are likely to be changed, made redundant or are critical to the transition. Some informal discussion at management level has occurred. Formal changes have not been made to employment conditions.
3. The firm has constructed a post acquisition scenario and identified employees who will be affected. Retirement, redundancy and key employee incentives have been constructed. Employment conditions have been changed to reflect the possible future sale of the business.
4. Key employee conditions have been discussed with key staff and as a result their conditions of employment have been changed to incorporate a retention bonus. A termination package has been incorporated into all

employment agreements to cater for redundancies. Bonus, commission, profit schemes and share purchase arrangements have all been modified to lapse on change of ownership. Professional advice has been sought on the arrangements.

5. Changes and incentives necessary to ensure a smooth changeover to a new owner have been reviewed by a professional advisor and fully implemented.

C15. Employment conditions, salaries and benefits are industry standard

Following any future acquisition of the investee firm, employees of the acquired firm will normally be integrated into the employment, health benefits and bonus systems of the parent company. When this happens, any deviations between the two schemes will have to be resolved. This is normally a time of considerable change in the acquired firm with employees fearful of their jobs. The less change that is imposed, the smoother this transition will be.

Where remuneration systems are industry standard, few problems tend to arise. Staff are neither paid too much nor too little. If the health insurance is standard and bonuses are in line with industry standards, these can normally be continued or transferred. However, if (say) vacation entitlements are overly generous, this can create problems where they need to be curtailed or need to be continued alongside fellow employees who receive less.

Self-assessment

1. Little or no effort has been made to ensure employment conditions are industry standard.
2. The firm has no formal process for setting pay scales or for performance evaluation. They believe they are paying reasonable levels to attract and retain employees.
3. The firm recruits employees at competitive rates but internal procedures for advancement are not checked with industry norms.

4. The firm is familiar with remuneration in their industry and tries to follow industry norms. An external review has not been made of their practices.
5. The company uses an outside firm of specialists to assist in setting pay scales and conditions of employment.

C16. Option schemes and benefits are compliant with stock exchange regulations

Many smaller firms offer incentives to attract and retain key employees. These include options, share purchase schemes, bonuses, share allocation and so on. Often these deals are done privately between the owner and the new employee. Sometimes advice is not sought on the long-term implications of these schemes on a possible sale of the firm.

Share purchase schemes and option schemes have attracted attention by both the financial reporting agencies and tax authorities around the world and so there normally exists a vast body of regulations governing these schemes. While a scheme might be legal and even appropriate for a small unlisted firm, the same scheme might be non-compliant for a listed company. Since most acquisitions are by listed companies, this can be a real problem for a future sale of the firm to a listed corporation. An employee will not be happy losing benefits and may well resist any such change if they have a contract in place which protects their benefits.

Self-assessment

1. Little or no effort has been made to ensure option schemes and benefits are compliant with stock exchange requirements.
2. The firm is familiar with the need to have compliant schemes but has made no effort to have their own schemes checked for compliance.
3. The firm has sought professional advice to check the degree of compliance of their schemes and to advise of changes which may be necessary.
4. The firm is implementing changes to their schemes to bring them into compliance.

5. Option and benefit schemes are compliant with stock exchange requirements.

C17. Due diligence files are complete and up-to-date

The purpose of due diligence is to check the health of the firm and to identify any potential risks. It also checks that the information provided by the firm is complete and accurate. Checks will include:

- supplier and customer contracts
- licences, patents, trademarks and IP management systems
- leases, distribution agreements and hire-purchase agreements
- employment contracts, health insurance and bonus systems
- complaints processing, dismissal processes and warranty systems
- quality control systems
- financial reporting systems, aged debtors and aged creditors
- reference checks with customers, suppliers and professional advisors
- background checks on key executives
- R&D, manufacturing and distribution processes
- banking relationships and loan conditions
- shareholder agreements, option schemes and share-purchase schemes.

The information required for a due diligence investigation is extensive and very time consuming to collect and collate. Often there are documents missing or incomplete. However, it is through this process that the Investor will uncover internal and external risks which can cause problems with their investment and may create problems in a later trade sale or IPO. A check of the documents themselves can often be a long and exhaustive process. Every contract, lease and agreement is sometimes checked to ensure that it does not overly expose the investor or acquirer. To the extent that professional advice from industry-knowledgeable legal and accounting firms has been used, this process can be dramatically shortened. Sometimes only a sample needs to be reviewed.

Self-assessment

1. The firm is not conversant with a due diligence process and preparations have not been made.
2. The firm is aware of the requirements of a due diligence process but does not have internal policies to ensure that records are complete and up-to-date.
3. The firm has a policy of maintaining complete and up-to-date files but has not had this process audited or checked compliance with this policy.
4. A professional audit of the accuracy and completeness of records has been conducted and recommendations are being implemented.
5. A complete and up-to-date file has been assembled to enable a full due diligence audit to be undertaken.

Operations Development Index

Nothing done	Little progress	Reasonable progress	Significant progress	Fully attained	N.A		
1	2	3	4	5			
Item	Attribute	1	2	3	4	5	N.A
C1	Monthly financial and key performance indicator reporting exists						
C2	A formal business plan has been prepared and is updated periodically						
C3	A formal budget is prepared and actual performance is monitored against budget						
C4	Full compliance with regulatory issues (eg. environmental, health and safety)						
C5	Customer relationships are managed to minimize litigation						
C6	Supplier relationships are managed to minimize litigation						
C7	Employee relationships are managed to minimize litigation						
C8	Credit worthiness with suppliers is excellent						
C9	Banking relationships are excellent						
C10	Customer interaction, contracts and agreements are industry standard						
C11	Supplier contracts and agreements are industry standard						
C12	Contracts can be assigned to an acquirer						
C13	Intellectual property is able to be traded and is appropriately protected						
C14	Post acquisition changes in employment are planned for						

Operations Development Index (Cont.)

Nothing done	Little progress	Reasonable progress	Significant progress	Fully attained	N.A		
1	2	3	4	5			
Item	Attribute	1	2	3	4	5	N.A
C15	Employment conditions, salaries and benefits are industry standard						
C16	Option schemes and benefits are compliant with stock exchange regulations						
C17	Due diligence files are complete and up-to-date						

D

Strategy

Firms seeking to raise Angel or Venture Capital finance often know very little about the nature of Angel or VC investment or the role and objectives of Angels and VC funds. Well established Angels and VC firms with good track records are actively sought by both investors and entrepreneurs and don't have the time nor the resources to deal with the many approaches they have, thus need to screen entrepreneurs seeking finance and concentrate their efforts where they can achieve the highest productivity for their time.

Investors often complain about the naivety of the entrepreneurs. Few they encounter really understand the purpose of Angel or Venture Capital finance or the criteria which they use to select investments. They often say that their first task is to educate the entrepreneur.

This environment provides, in fact, a very fertile ground for the entrepreneur who approaches the Investor with a well thought out proposal put in terms which they can appreciate and with the support of a professional advisor they respect. Where they can be assured they are being offered a chance to look over a proposal which has been reviewed by a knowledgeable professional advisor, it makes their life easier and more productive. In fact, some Investors won't entertain looking at a proposal unless it has come from a respected angel or professional advisor.

Even when the Investor is approached using the proper channels, the well prepared entrepreneur must still be able to deliver a written proposal in a form which allows the Investor to easily evaluate the investment in their terms – that is from the viewpoint of the

investor not the business builder. The proposal should be backed up with a management team who can clearly articulate the benefits of the business in terms of growth, ROI, risk exposure and likely exit and do so in non-technical language.

The entrepreneur should also be well versed in valuation techniques and normal terms of Angel or VC investment. Discussions with an Investor will be much more meaningful and productive if the entrepreneur understands how Angels and VC funds work, how they manage their investments and how they achieve a harvest on their investments. Using a professional advisor to educate, advise and assist in this process will ensure that neither the entrepreneur nor the Investor waste their time.

D1. Investment advisors have been appointed

Few entrepreneurs ever have the experience of raising Angel or VC finance and even less do it more than once. Thus few ever build up the required knowledge and experience to efficiently work through the requirements. A professional advisor who deals with Angels and VC funds on a frequent basis not only understands the requirements of the investor but should have contacts within the investor community to best advise the entrepreneur on which investors to approach.

The process of securing an investment requires the firm to prepare a wide array of information, not just on the business concept itself, but extensive information on the business for the due diligence process. The professional advisor can assist in the preparation of the investment proposal as well as ensure that the firm is well prepared for the due diligence activity. A credible and experienced professional advisor will ensure that the firm does not waste their executive time pursuing the wrong strategy. Angel and VC investors have a specific set of business and legal requirements and the firm needs to ensure that it can meet these conditions.

Part of the process of selecting a professional advisor should be some form of reference checking as well as a degree of comfort and fit between the parties. A firm which knows what it is doing should have little hesitation in providing references to clients which they have assisted through the same process.

Self assessment

1. Advisors have not been approached or appointed.
2. Advice has been sought as to which advisors the firm should work with but approaches have not been made.
3. The firm has made an approach to one or more advisors and discussions have commenced but appointments have not been made.
4. The firm has negotiated terms with one or more advisors, undertaken reference checking and interviewed one or more clients which the advisor(s) have assisted but agreements have not been entered into.
5. An investment advisor has been appointed.

D2. An equity investment/debt strategy has been formulated

Angel and VC investment should be part of an overall funding strategy being constructed for the business. While equity investment has the advantage that it has no repayment risk associated with it if the business is temporarily unable to fund dividends, it does dilute the founders equity. On the other hand debt, while not diluting equity holdings, does carry a risk in the event of non payment of interest and principal. Failure to pay interest when due or to make the periodic loan repayments can result in the business being put into receivership and perhaps assets seized and sold. Thus finding the right balance between equity dilution and repayment risk is essential for longer term funding of the business.

The firm should be prepared to discuss the financing strategy with the Investor and be able to show how the business will finance any external debt which it intends to take on. Generally the Investor will require the firm agree to seek the Investor's permission before it commits to any additional external debt.

Self assessment

1. A strategy for the use of debt and/or equity investment has not been formulated.
2. The firm has identified a need for funding but has not translated this into how much or what mixture of debt and equity would be appropriate.
3. A plan incorporating a desired level of debt and equity has been constructed but this has not been tested against the business plan to see if it will adequately cater for different levels of success in business outcomes.
4. The funding model has been incorporated into a business plan and has been tested against various scenarios.

5. The funding model has been reviewed by a professional advisor and adjusted accordingly.

D3. A realistic valuation formula has been constructed

The valuation of the business prior to an Angel or VC investment (pre-money) is usually a contentious issue for both founders and investors. The founders clearly want as little dilution as possible while the investors want the downside protection of a low valuation going into the deal. Unless both parties can move past the valuation issue, no deal will be consummated.

Most Investors will argue for a lower valuation based on their experience of past investments which went sour. Even when everything looks positive at the outset, their experience shows that forecasts are rarely achieved and activities take much longer than anticipated, thus their initial valuation needs to reflect this. On the other hand, the founders will want to hold onto as much equity as possible, especially if the venture proves highly successful. If the initial opening positions are too far apart, it is possible the discussions will simply be terminated and no investment will be forthcoming. It is in the interest of the firm to start with a realistic valuation and negotiate from that position. In the end, a formula based valuation may be the best way to resolve any major differences in valuation.

Self assessment

1. A valuation figure or valuation calculations has not been undertaken.
2. Crude valuations have been discussed based on market transactions and industry norms but specific calculations have not been made.
3. Conventional valuations using a fair market value formula have been undertaken. Market information of similar transactions has been assembled.
4. Valuations have been reviewed by professional advisors. Market information of similar transactions has been reviewed with the professional advisor to identify appropriate norms.
5. A valuation formula has been constructed to reflect different possible outcomes at exit. A preferred valuation or formula has been documented with reference to fair market valuation and recent industry transactions.

D4. An executive summary and an investment business plan have been prepared

Most businesses seeking external investment will have prepared a business plan but few will have constructed the plan with the requirements of the Angel or VC investor in mind. Most business plans are designed to develop the business rather than to show the Investor how they can protect their investment and achieve their exit requirements. An investment business plan needs to be constructed somewhat differently from a normal business plan.

Investors are unlikely to be familiar with the intricacies of the business and its marketplace, thus the business plan needs to place the business into a context of customers, benefits, competitors and market dynamics. Within this context, the investment business plan needs to show how and why the business will be able to achieve the revenue and profit projections and show how these numbers have been validated.

Investors often deal with hundreds of proposals and so a well articulated executive summary needs to encapsulate the essence of the business opportunity, the investment required, the proposed exit strategy and the expected returns to the Investor. Unless the summary captures their attention, it is highly unlikely the rest of the business plan will be read.

Self assessment

1. A summary or business plan has not been prepared.
2. Financial projections and annual budgets have been prepared but do not contain information which would enable the business to be evaluated by an external party.
3. A business plan has been prepared for the normal operations of the business but does not reflect the special needs of an Investor.
4. An investment business plan with an executive summary has been prepared specifically for the purpose of raising equity investment but has not been reviewed by a professional advisor.
5. An investment business plan including an executive summary has been prepared specifically for raising equity finance and has been reviewed by a professional advisor and adjusted based on their advice.

D5. Appropriate Investors are identified

While there are many Angel and VC investors, each one has their own preferred investment objectives which are based on their industry experience, the amount they have to invest, the time they have available to manage their investments, their existing commitments, travel preferences and so on. Just because an opportunity looks compelling from an ROI point of view, does not mean that investors will be flocking to review the proposal. They will know they will often have to get involved with the management of the business or with the development of its market penetration or the final exit. These often require familiarity with the sector and possible access to alliances, senior executive talent and possible corporate acquirers.

At the same time, their desire to invest may depend on what other investments they have and their risk tolerance. An Investor which has substantially allocated their investable funds may not be in a position to make new investments. A VC fund which is fully allocated may not be in a position to allocate new funds for some time. Angels and VC funds need to balance their investments across different risks, thus an Investor may feel over extended in one sector and not be willing to make further investments in that area. Alternatively, a different Investor may be seeking investments in the firm's sector.

Self assessment

1. Investors have not been identified or approached.
2. Angels and/or Venture Capital firms have been selected based on location and personal introductions but this has not been done scientifically or with the advice of a professional advisor.
3. A number of Investors have been identified based on their preference for industry sector, size of investment and geographical preference but reference checking has not been done and no professional advice has been taken.
4. Professional advice has been sought on the selection of Investors and a small number identified for approach but no reference checking has not been undertaken.
5. A select number of Investors have been identified based on their preference for industry sector, size of investment, geographical preference and so on. References have been sought from current and former investees and other professional parties.

D6. Creditable introductions to Investors are achieved

Some Investors have a policy of not reviewing unsolicited proposals. This is partly based on the fact that they have a good pipeline of referred proposals from professional advisors, former investees and colleagues but also because they simply don't have time to read a proposal which has not been professionally prepared and reviewed before they see it. Investors prefer not to waste their time with poorly prepared information or with unrealistic proposals. They expect proposals which they receive to have been referred to them by knowledgeable persons and that they will not only be complete but also the applicant will have realistic expectations on valuation.

Investors often complain that they spend too much time educating the entrepreneur about how Angel or VC investment works. Some of the conditions attached to an investment are confronting to an entrepreneur, especially when they see there is a chance they may lose control of their business or their business can be sold from under them. While these conditions may appear harsh, they reflect the reality of dealing with high risk ventures where liquidity is a serious issue. Rather than having these difficult discussions, the Investor would rather deal with proposals which have already taken into account the manner in which the investment will be constructed and managed. At the same time, they would rather deal with proposals which have the necessary information in them to allow them to undertake a proper evaluation.

Self assessment

1. Introductions have not been arranged.
2. The firm has secured a letter of introduction from friends or a suburban accountant or lawyer. The contacts with the Investor are not personal and are mostly ones of professional courtesy.
3. Personal introductions have been arranged by friends and acquaintances of the Investor. These individuals, however, are not familiar with Angel or VC investments.
4. Introductions have been arranged to the Investor by individuals knowledgeable about Angel and VC investments but not specifically about the preferences of the specific Investor.
5. Introductions have been arranged by creditable professional advisors and/or other investors who are actively involved in Angel or VC investment transactions and are

known to the Investor. The introductions have taken into account the investment preferences of the Investors being approached.

D7. Key messages are practiced and refined

Investors evaluate many proposals before they make a single investment, thus they tend to use their time as efficiently as possible. They look for a venture team which can clearly articulate the essence of both the business and the investment proposal. This is not just because it helps them in their evaluation but because they know the team will have to do this task many hundreds of times to customers, suppliers, alliance partners and potential employees. A venture team which is unable to provide a precise definition of who they are and why they are going to be successful probably has not yet come to grips with the essence of the business and how it needs to be developed to be successful.

The vision of the business needs to be both compelling and succinct. The business concept should clearly show how and why the business will be successful. The investment proposition should show how much investment is required, what it is going to be used for, what exit strategy will be undertaken and what return the investor can expect to receive on their investment. The investment proposal should be presented in non-technical terms if appropriate, be able to be adapted to different presentation lengths and show that the supporting detail will demonstrate validation of the critical business issues.

Self assessment

1. No effort has been made to develop a clear vision and definition of the business concept.
2. The firm can discuss their venture knowledgeably but this has not been tuned for an investment audience.
3. The vision and definition of the business concept is well understood and has been developed for an Investor but is too long, overly technical, lacks flow or is not convincing.
4. The firm has developed a series of presentations for Investors including a short pitch and a 20-30 minute business plan presentation. This has been tested and practiced with colleagues and friends.
5. The firm has a well articulated set of informal and formal presentations which have been reviewed with professional advisors and suit a variety of different technical and non-technical audiences.

D8. Multiple Investors are engaged

A good proposal should be offered to a small number of selected Investors. This is not to suggest that it is shopped around, but each Investor will have their own portfolio strategy and the worth of your venture, while attractive, may not suit the investment position or timing of some of the Investors. You also want to have the opportunity of comparing what additional value each Investor can bring to your venture. If the money available is the same across the Investors, their added contribution in terms of networks, access to experienced staff, ability to open doors to alliance partners and potential customers should also be evaluated.

You also need to be comfortable with the people you will be dealing with, especially the Investor or Investor's representative who will be sitting on your board. You don't want to find yourself stuck with someone who has a different view of the world or a different cultural or ethical position. It may be the case that the terms under which the Investors are willing to invest are different in which case you need to weigh up the different tangible and intangible benefits. Some may be much more willing to negotiate a formula based valuation, for example.

Self assessment

1. Investors have not been engaged.
2. The firm has approached a number of Investors but has yet to move to a second round of discussions.
3. Detailed discussions have been undertaken with several Investors and some level of interest has been expressed.
4. Discussions with a small number of Investors have progressed to strong expressions of interest or one Investor has been selected for extensive discussions. A professional advisor has reviewed the discussions and advised on which Investor to proceed with.
5. A small number of Investors have expressed strong interest and the firm has agreed to proceed to develop a Term Sheet with them. A professional advisor has recommended which Investor should be taken to Term Sheet stage.

D9. Offers received and negotiated

After the various Investment offers have been evaluated and some due diligence undertaken on each of them, Heads of Agreement will be negotiated. This is something that must be negotiated as there are many possible components to the investment deal. You should spend some time prior to the meetings becoming familiar with the normal terms of an Angel or VC investment and request clarification from your professional advisor if you are not familiar with the implications of the various terms and components.

The verbal offer which you receive is not necessarily the last position of the Investor. Investors are competing for your business in the same way that you are seeking theirs. You should be trying to find a balance between your interests as founders and shareholders with theirs as independent investors. If you push your position too hard, however, you will probably not end up with a deal. But marginal aspects of the deal may still be subject to movement on their side and you may be willing to offer some concessions on yours. In the end, however, you still need to make the numbers and the timescales to protect your investment in the business.

Self assessment

1. Offers have not been received.
2. At least one Investor has expressed strong interest but no discussion of an offer has eventuated.
3. One or more Investors have expressed strong interest and have discussed the investment evaluation process with the firm. One or more have indicated that offers would be forthcoming after some additional due diligence steps have been undertaken.
4. One or more Investors have indicated the broad terms of an offer. These have not been responded to and not reviewed with the professional advisor.
5. Verbal offers have been received by the firm and have been reviewed by the professional advisor. A response has been given to at least one Investor which indicates that a written Term Sheet would be seriously considered.

D10. Term Sheet received and negotiated

The Term Sheet is the formal offer by the Investor. This will be issued only after they have reached an understanding with you and have done initial due diligence on the firm and the market opportunity. The Term Sheet means they are ready to put some serious time into the full due diligence and working with you to make sure each party has a full understanding of the journey that you will undertake together over the next few years.

However, even a Term Sheet can be negotiated to some extent. Often additional clauses have been added by the Investors which have not been fully discussed or they have assumed you are familiar with. These need to be examined, often in conjunction with a professional advisor and then clarification sought. Sometimes minor items within the Term Sheet can still be negotiated.

Often at this point, you have settled on your preferred Investor and only one Term Sheet will be dealt with. Providing you have done your reference checking and are comfortable with the Investor and the deal, there is no reason why you should not proceed at this point. Make sure all the parties to the agreement on your side are willing to sign off on the deal.

Self assessment

1. Term Sheets have not been received.
2. A Term Sheet has been received but is unacceptable or has not been responded to.
3. Negotiations on the Term Sheet have commenced but there is still some gap between the parties.
4. Negotiations have concluded on the Term Sheet and verbal agreement reached on an acceptable arrangement. The firm is waiting on a new terms sheet.
5. A Term Sheet has been received which is acceptable to the firm and has been recommended by the professional advisor.

Strategy Index

Nothing done	Little progress	Reasonable progress	Significant progress	Fully attained	N.A		
1	2	3	4	5			
Item	Attribute	1	2	3	4	5	N.A
D1	Investment advisors have been appointed						
D2	An equity investment/debt strategy has been formulated						
D3	A realistic valuation formula has been formulated						
D4	An executive summary and an investment business plan have been prepared						
D5	Appropriate investors are identified						
D6	Creditable introductions to investors are achieved						
D7	Key messages are practiced and refined						
D8	Multiple investors are engaged						
D9	Offers received and negotiated						
D10	Term Sheet received and negotiated						