An Introduction to Financing Your Business with Venture Capital

Business Information Factsheet
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Introduction

Venture capital is a type of third-party equity investment that is used to fund business growth. Venture capital firms raise investment funds from a variety of sources, such as pension funds and endowments. Under a venture capital agreement, the business owner effectively sells the investor a stake in their company in return for finance.

This factsheet provides an introduction to venture capital. It outlines the pros and cons of using venture capital to finance a company, and discusses the suitability of venture capital for different types of business. It explains how to approach investors, the process involved in negotiating an investment deal, and outlines sources of professional support for business owners who are considering approaching investors. This factsheet also explains what happens when an investor 'exits' at the end of the investment period.

What is venture capital?

Venture capital is finance for entrepreneurs and start ups, provided in return for an equity stake in their potentially high-growth companies. Venture capital firms usually invest for the medium to long term, with a typical investment period being between five and seven years.

Venture capital is not like debt finance. Investors share the risk with the company they invest in, with the aim of making high returns on their investment when they 'exit' the arrangement. Since their returns depend on the company's ability to grow, the investors expect to have a say in its business decisions.

When is venture capital appropriate for a business?

Venture capital firms have strict criteria that must be met before they will consider investing. Generally, investors look for:

- A sound business model, with a clearly defined market and a clear competitive edge.
- High growth potential.
- A balanced, experienced and highly competent management team.
- An achievable exit opportunity in five to seven years.

Business owners should only consider financing their business through venture capital if they are prepared to give up ownership of part of the business. A business that is run as a 'lifestyle', or one in which the owner wants total control, is not likely to attract venture capital funds; neither is a business with chronic problems or one that needs temporary help with cash flow.

Advantages of venture capital

The advantages of venture capital are:

- The investor provides advice and support to help the business succeed: their return depends on the success of the business.
- The investor provides valuable expertise and often has a network of useful contacts.
- The investor generally appoints a non-executive director (see BIF322, A Guide to Appointing Non-executive Directors), imposing external discipline on the way the business is managed.
- Venture capital firms often work with other finance providers or business advisers and may be able to create a broader finance package for the business.
- Since there are none of the cash flow challenges associated with repaying capital and paying interest as there are with debt finance, the investment can be used solely to grow the business. Dividend and possible capital repayment usually only happen once the business is profitable.
- The investor shares the risks with the entrepreneur. If the business runs into problems, the investor will work with it to try and achieve a successful turnaround.

Disadvantages of venture capital

Key disadvantages include:

- Securing an investment can be time consuming, complex and costly.
- The owner will have to give up a share of their business and the business is exposed to outside scrutiny.
- The owner will need to give up some element of personal control over the business direction, working with a non-executive director appointed by the investor.
- The management structure might have to change, bringing in new people to fill gaps in expertise - all of which adds to the cost.
- The investment agreement will impose legally binding covenants to protect the investor's interests, such as requiring their approval for major business decisions and placing caps on directors' salaries.

Approaching investors

The British Private Equity & Venture Capital Association (BVCA, www.bvca.co.uk) publishes a list of member firms, their contact details and the types of funding that they provide.

An up-to-date business plan is essential for presenting the business to potential investors. A good business plan should:

- Demonstrate that there is a market and a realistic strategy to develop the business.
- Detail the right people needed to execute the plan.
- Show clearly how much money is needed, for how long, and what it is needed for.

- Provide detailed financial forecasts to show how investors will be able to achieve an attractive return on their investment.

See BIF004, A Guide to Writing a Business Plan, for further information.

The centrepiece of the business plan should be a two-page executive summary that can be sent as a stand-alone document. Sending this to a few potential investors can help gauge how viable the plan is: any negative feedback or questions can be used to reassess strategy before approaching further investors.

An interested investor will want to meet the business owner and the management team to discuss the business plan in more detail. This is an important opportunity for the owner to impress the investor with their knowledge and understanding of the business, its market and the reliability of the assumptions used in the forecasts.

Negotiating the investment deal

The main areas for negotiation are:

- The amount of money to be invested, and the percentage ownership that the investor will receive. This hinges on agreeing a current valuation for the business.
- The structure of the funding package. This includes the amounts to be provided as ordinary shares, preference shares, or debt, whether the money will be invested as a lump sum or in stages, and whether the investor requires co-investors.
- The key investment terms that the investor requires.
- The costs of items such as due diligence and legal fees, and who will meet these costs.

When broad agreement is reached, the investor provides an offer letter outlining the main terms of their investment proposal, which will be subject to due diligence and contracts being signed.

The owner will be in a stronger position to negotiate a more favourable deal if more than one investor is interested in the business.

Due diligence

After broad agreement has been reached, the investor will want to go through due diligence - a process that appraises what they have been told about the business and its potential, and to make sure that there are no hidden problems. Due diligence typically involves a review of:

- Current financial details and forecasts.
- Compliance with legal and tax obligations, such as VAT and PAYE.
- Contracts with customers, suppliers and employees.
- Details of any litigation.
- Assets and intellectual property (IP) owned.
- Business management processes.

Due diligence is the stage at which many deals fail. It is therefore vital that the business is well prepared for the process, ensuring that all records are accurate and up to date, and that business controls are in place. Due diligence is usually carried out by accountants who visit the business premises; the owner needs to devote a considerable amount of time to them when they are on-site.

The investment agreement

The investment agreement is a formal document based on the investor's offer letter. The agreement legally binds the two parties to the agreed terms. It is drafted by the investor's lawyer and is then subject to negotiation to ensure that the terms are agreeable to both parties. The business owner must take legal advice during this part of the process to ensure they understand the terms in the agreement. The investment agreement formalises:

- The amount and form of the investment.
- The specific rights of the investor.
- Warranties to confirm that the information provided to the investor is true.
- Indemnities so that the owner accepts liability if certain events happen.
- The obligations of the directors and service contracts to tie in management and staff.

The terms of the investment agreement will require the company's Articles of Association and any existing shareholder agreement to be amended to reflect the specific rights of the new investor.

The investment process is completed when both parties sign the investment agreement and the funds are paid to the company.

The BVCA has some model documents for early stage investments at www.bvca.co.uk/Policy/Tax-Legal-and-Regulatory/Industry-guidance-standardised-documents/Model-documents-for-early-stage-investments.

Investors' exit routes

Investors typically exit from their investment after five to seven years. There are three primary exit routes:

- A buy-out of the investor's stake by the company or the other shareholders. This is the most common exit route, although it is only possible if the company has built up enough distributable reserves or if the other shareholders have enough spare cash.
- A trade sale. Another business buys the whole company, enabling all the investors, including the original business owner(s), to get their investment back.
- Flotation on a stock market (often known as initial public offering, or IPO). This is the preferred route since it can lead to the biggest gains, but it is also the least common because most companies simply do not grow enough to float.

The investor generally reserves the right, in the absence of a suitable alternative, to sell their shares to a new investor, although this rarely happens.

Professional support

Most business owners do not have experience of trying to raise venture capital, making it crucial that they take appropriate professional advice. Business advisers, lawyers and accountants all have a role to play in the venture capital funding process.

The key aspects of raising venture capital that professional advisers can help with include:

- Reviewing the business plan and its forecasts.
- Valuing the business.
- Calculating how much funding is required and how the investment could be structured.
- Working out and planning for tax implications.
- Drafting a business plan.
- Making introductions to appropriate sources of venture capital and other finance.
- Reviewing offers of finance and helping the business owner negotiate the best possible deal.

Although it can be expensive to use professional advisers, the benefits are substantial, particularly as this enables the business owner to concentrate on running the business. Advisers should have experience of venture capital investments in a similar business or industry, and the business owner should always obtain fee estimates before engaging them.

Hints and tips

- Consider other sources of finance before deciding on venture capital. These include grants, loans, overdrafts, equity crowdfunding, peer-to-peer lending, factoring, leasing, hire purchase or personal funds.
- Seek advice from a professional adviser before starting to look for venture capital. This can save time and effort, especially if they advise that venture capital does not suit the business.
- Before starting the process, ensure that the business is being managed as efficiently as possible, with robust systems and procedures in place to maximise profitability and efficiency.
- Make sure that all records are up to date and all necessary business controls are in place.
- Don't underestimate the amount of time needed. Even after finding an interested potential investor, the investment process typically takes between three and six months - and while it can be quicker, it can also take much longer.

Further information

BIF004 A Guide to Writing a Business Plan
BIF032 Choosing the Right Business Legal Structure
BIF038 Choosing and Using an Accountant
BIF040 Sources of Finance for Starting a Business
BIF167 A Guide to Setting up a Private Company Limited by Shares
BIF283 Methods of Valuing a Business

BIF322 A Guide to Appointing Non-executive Directors
BIF324 An Introduction to Approaching Business Angels

Useful publications

The 'Venture Capital Schemes Manual' is an HM Revenue & Customs (HMRC) publication which details the venture capital schemes on which investors may claim tax relief.
Website: www.gov.uk/hmrc-internal-manuals/venture-capital-schemes-manual

Useful contacts

The British Private Equity & Venture Capital Association (BVCA) provides publications, data and guidance on all aspects of private equity and venture capital funding.
Tel: (020) 7492 0400
Website: www.bvca.co.uk

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