

Raising Venture Capital In Tough Times

By Robin C. Johnston

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It's no secret that it's not as easy as it used to be to raise money for your business. Longer investment cycles, suppressed valuations, and limited opportunities to cash out of deals has made venture capitalists increasingly selective. As a result, many VCs look only at companies they know and have invested in before, rather than pursuing new deals.

According to Jeanne Metzger, VP at the National Venture Capital Association (NVCA) in Arlington, Virginia, "The rules that applied in the mid '90s now apply again. In the late '90s, you saw venture capitalists take more risk in terms of really early stage deals with inexperienced management. Those risks were warranted as the appetite for tech IPOs was high. Now, in a market where liquidity is several years down the road, venture capitalists are being increasingly cautious."

To get financed today, companies need customer traction, a solid understanding of the market, proprietary access to unique technology, and alignment with potential funders on the commercial vision for the product and company. Above all, they need good people.

Here's what to do to prepare your business for joining The Few, The Proud, The Funded.

Step One: Solve a Customer Problem

Businesses must solve some real problem for a definable set of customers. Before the technology bubble burst, many companies tried to invent customer problems in order to show how their technology solved them. What utter nonsense! Pursuing technology for technology's sake rarely leads to success. The main market usually couldn't care less about the latest and greatest. According to venture capital guru Guy Kawasaki, there is only one correct answer to the question, "What makes your technology so great?", and that is "Because there are customers with money that want to buy it!" Fail that test and you should realize that, although the technology may be fantastic, the business you're building around it is worthless.

Particularly in a down economy, the only things that matter to paying customers are those that offer clear opportunities for sales generation or expense reduction. Products must provide immediate and obvious impact. What's more, startups need to have worked this out well before seeking funding, because investors will not sustain a long education phase while managers try to figure out what customers want.

Step Two: Build your Management Team

Great ideas have withered and died in the hands of managers who don't know what to do, but proper execution can bring impressive results with even an average idea or product. This is why

VCs obsess over management teams. Execution is key. Better teams mean better execution, which means better startups and ultimately better deals for all involved.

Investors look for managers with successful startup experience and strong track records in large-company best practices environments. They also expect deep industry knowledge and an unquenchable customer focus. Startups are not friendly, nurturing environments. It takes unbelievable commitment, stamina, and thick skin to stick it out to any kind of liquidity event. It doesn't matter how well groomed a pony is, if it can't make it to the finish line.

Although it has been said that, "Only the paranoid survive", paranoia and arrogance are warning signs for investors. After funding, founders are often asked to assume different roles or exit the company altogether, so they must be prepared to walk away from their post. This can be a very painful reality, and the "it's my baby" syndrome has cost many entrepreneurs their funding opportunity.

When it happens, the impact of a top-management change can be severe. A small company is like a piece of cloth. Pulling out a single thread in a poorly planned founder transition can make it fall apart.

Step Three: Develop customer evangelists in an emerging market

There is no substitute for a long list of happy, paying customers. Even better are a few very vocal accounts that would never leave you, and would be delighted to tell anyone why you're the best. Get to this stage, and the funding battle is half-won.

Early in the courtship, many VCs only want to hear about customers. What problem does this product solve? How big a problem is it? How many potential customers face this problem? How much will they pay to solve it? What alternatives do they have to this solution? These questions will come up in the due diligence process – be ready for them, and make sure your answers are verifiable. VCs expect a company's own management to exaggerate the size of the market opportunity. As a result, funders heavily discount what they hear from management teams. The best answers are those supported by external, independent validation. What are the industry analysts saying will happen? What are customers actually doing?

Historically, companies selling a proven technology into an emerging market achieve the best returns. Proven technologies represent little risk of failure, and emerging markets imply rapidly increasing sales. Consequently, companies in this environment are those most aggressively pursued by venture capitalists.

Step Four: Find your P2P

In the turbo-charged '90s, the mantra "Ignore everybody who does not contribute to the top line!" was key to opening wallets along the funding trail. While still critically important, sales are no longer enough. Investors have soured on the idea of pouring millions into startups with respectable top-line numbers, but with no chance of making money. Sensibly, the focus today is on path to profitability, or "P2P". You've got an interesting product – okay. You've got customers – good. You've got sales – great. But how are you going to make me money?

Develop realistic projections, and show a bulletproof P2P. Remember that profit is nature's way of telling you that you are adding value. Unless you can prove you're adding value, don't waste your time looking for funding.

Step Five: Choose Your Partners, and Hit the Trail

Financial partners are not created equal. It pays to be clear on what you are looking for, and to get to know potential funders before signing a deal. Do your due diligence on them, as they do theirs on

you. Call several companies they've funded; not just the names they give you. What is this investor really like? Will they let you do what you think is best, or muscle in and take an active role in day-to-day management?

Venture capitalists focus on working with different types of companies. Look for someone who already knows something about your business and who, hopefully, is already doing work in your space. There are as many different styles as there are VCs, so pay close attention to what you see and hear, and consider carefully whether there is a fit.

A raging party started in Silicon Valley and swept across the country in the late '90s. Now the party's over, the patrons have sobered up, and legitimate entrepreneurs are being asked to pay the bar tab and clean up the place, before anyone will buy them a drink. It's not that these are particularly tough times for raising money. It's the contrast between the way it was just a few short years ago, and the sober practices we've returned to.

What's a poor entrepreneur to do? The NVCA's Metzger sums it up, "The keys to raising venture capital today are having: 1) a well thought out business plan, 2) an experienced and high quality management team in place, and 3) [a market with] large growth potential." Stick to the knitting, and pay attention to the fundamentals.

Take care of the basics, and the money will follow.

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