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OIL PRICE GAINS $1.22 (U.S.) TO $61.10 A BARREL. FULL MARKETS COVERAGE

WEDNESDAY 15.03.06

REPORT ON BUSINESS

S&P/TSX	DJ Ind.	Nasdaq	Dollar	Gold
11,826.44	11,069.06	2,262.96	87.18c (U.S.)	$556.60 (U.S.)
-39.32	-46.26	-19.40	Unchanged	+2.00
Energy stocks lead first decline in four sessions	Interest rate worries undermine blue chips	Chip stocks drop as Citigroup cuts recommendation	Rate concerns in U.S. and Canada squeeze loonie	Renewed inflation concern underpins bullion gain

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VENTURE CAPITAL

What a VC Wants

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WISE WORDS

In the 2000 romantic comedy *What Women Want*, Mel Gibson gains the ability to hear women's thoughts. His new found ability yields insight into an enigmatic world and expands his previously limited horizons.

In the last 30 days, I have been approached to raise Venture Capital on behalf of many ventures, including a dog treat manufacturer, a new toilet seat cover designer and an on-line simulated hockey league. After listening to their pitches it was clear to me, that like Mel Gibson who struggled to gain insight into the mysterious minds of women, some people are often stuck in an abyss when trying to understand the minds of Venture Capitalists.

While I doubt that I will ever truly gain, let alone be able to share with you, insight on Mel's discovery I was able to touch base with five very different venture capitalists and ask their opinion on what VCs consider fundamental when (or before) making an investment. Even though each VC investor comes from different parts of the world and each focuses on very different sectors and stages of investment, they more or less independently came up with the same five core elements that get them excited about a deal. So while I can't shed any light on what women want, I may be able to illuminate what most VCs need before even considering an investment.

1. A large opportunity

As discussed in previous articles, the size of opportunity (a.k.a. the total addressable market) can be calculated, as the size of the pain multiplied by the quantity of customers experiencing that pain. Experienced VCs know that your venture is most likely only going to get a modest market penetration at least at first and hence, they figure that you are only going to pick up at best a small portion of the total addressable market. Therefore, your company will need to have a large enough total market, to make even the smallest segment valuable. This is why you need an expansive market with a large pain to attract VC funding.

"Size of market is key. Within the next 3-5 years the market that the venture is going to sell into must show a demand of at least half a billion with double-digit CAGR [Compound Annual Growth Rate]," says Larry Lam, from BDC Venture Capital. However, the overall size of the market isn't as important as the pent up demand or the pain that needs to be addressed. "The product must create value for the customer, they must really want it. It either needs to solve a big problem they have or lead to some better state in the near future," adds Les Lyall, Senior Vice-President at Growthworks, whose funds invest in almost all sectors and stages.

The ability to gain traction and the need to scale (see #4) all increase the likelihood of generating a high exit value (#5). All three of these items are dependent on the high (or expressed) demand for your product. The market or pain cannot merely exist. It is imperative that the market be big enough that the people struggling with a problem will be inclined to pay for a (or the) solution.

As an example, let's use e-mail spam fighting software. We have all received thousands of unwanted email advertising, with subject headlines such as body enlarging herbs and get rich schemes (among others). How much would you pay to clear your inbox of these unwanted messages? Now think of how much Corporate America would pay. In 2004 the cost of spam to Corporate America was over $21B, reflective of a market with a large pain.

2. Strong competitive advantage

It is not enough to simply target a market with a large pain. Once you have begun dominating your addressable market, you must be able to defend (or secure) that territory.

Competition comes in many forms, including direct, indirect, alternatives, and of course the one that most start-ups never think about, *Status Quo*. But assuming the pain is big enough (see #1), then the status quo menace or the "we are fine the way we are, so we don't need to buy your product" is mitigated; you will still need to address your competition.

If anyone can easily replicate what you are doing, then you are likely to face two large sources of competitive pressure. The first one comes from other startups and incumbents. It will not sit well with investors, if others can easily pursue a venture that is similar to yours. The second comes from the "buy vs. build" decision. If your future clients feel that the product while good isn't very hard to build, they might decide to simply create their own version internally and leave yours on the store shelf. Regardless of the type of competitive pressure confronting your new venture, it can have devastating effects.

This is often why VCs want intellectual property, especially with early stage companies who don't yet have deep relationships with customers. Investors want affirmation that once the product receives traction, you can defend your hard fought market share, not only because your venture has the best solution to the customer's problem, but because your IP locks out others.

IP is also important when it comes to achieving a high exit value (#5). If you are able to lock other solutions out of the market with your IP, then it is more likely you will be acquired by those wishing to sell into your customer base, since they can't build it themselves; they either need to license it from you, or buy you outright.

Revisiting the spam situation, a company that has a patented solution to block spam in a novel way more accurately than any other solution, will more likely find itself in the M&A sights of vendors, who sell email solutions to Corporate America. If the future acquirer can simply build a similar system, then the value proposition for acquisition drops dramatically.

But not all investors think IP is the strongest barrier to entry. Kevin Effusy, a Partner in the Silicon Valley based Accel Partners, who focuses on wireless, software and Web 2.0 ventures, expresses that while IP is nice to have, nothing beats customer traction. More specifically, he states that "The network effect (e.g. the service becomes stronger as more users sign up) and building pervasive technology (a platform upon which others build, making it harder to later replace the underlying platform) can be huge competitive advantages" and can likewise act as strong barriers to entry. One has only to look to Skype, eBay or Facebook, to see the former or JBoss and Microsoft to witness the latter.

Notwithstanding, it is less important where your strong competitive advantage and barriers to entry come from; all that matters is that you have them.

3. Management

Salim Teja, Vice-President with BrightSpark Ventures, a seed investor focusing on Software, says "Sixty per cent of the investment decision comes down to the quality of management. Amongst other things, we look for founders with deep technical expertise. Bring us the best in the world in his area, and we'll be interested. It is not enough to just be a bit better though, today to win clients, you need to be exponentially better and to do that you need deep technical expertise on your team."

Most investors agree that a brilliant technologist is needed for the team, since it is technology that often produces the competitive advantage (see #2) but technical knowledge is only one part of the management equation. According to Benoit Hogue, from Montreal based Propulsion Ventures, many VCs also like to bet on founders with extensive domain knowledge. "Management is our first criteria and we measure quality along two key axes: one - deep domain expertise and two - the killer instinct to succeed" says Hogue. "We want someone who understands the customers pain (#1) and will ensure the solution being built addresses such. Otherwise you can end up with good technology that simply won't sell."

Killer instinct was also important to David Raffa, a Partner with BC Advantage Funds, an early stage VC on the West Coast. Raffa says "Venture capital is all about three things: people, people, people. I look for a bright, cohesive A level team that simply will not be denied. No matter how smart you think you are, or how great your technology is, you are going to face both expected and unexpected challenges. How the team responds to those challenges will be the difference between a good idea that dies, and a good idea that goes on to become a great one."

Once again, let's reflect on our e-mail spam example. Do you think it is more important to understand the mind of the Corporate CIO who will potentially buy the product or simply build the best technologically sound spam blocker? The answer is neither. Ideally, VCs want to invest in management teams that can do both and do so with that "we won't be denied" attitude.

4. The Ability to Scale

In a nutshell, to be scalable from a VC's perspective, means that as you roll out your product, the costs associated with it do not increase in lockstep with the revenues. On-line software businesses are extremely scalable. Once you have built the first unit, the costs have sunk and you need not rebuild the product to sell it again. Conversely, consulting businesses are not very scalable. Increasing revenues necessitate a larger staff, billing more hours or selling at a higher price, all of which may be feasibly capped as you roll out your solution. This is why VCs typically don't invest in consulting businesses, IT outsourcing companies or ventures that are purely service oriented; they simply don't scale.

"We look for companies that can conceivably be grown to a large size quickly while maintaining, or better yet increasing, profit margins," says Les Lyall. Benoit agrees that "VC money is the wrong medicine if you can't scale. There is nothing wrong with a business doing $10M in revenues with $1M in profits. In fact, I'd quit my job to own one, but if that is as big as it can get, that's not for VC investors."

5. The potential for a high exit

Raffa, comments that "A logical buyer needs to be self evident … although in the end, some deals get done with buyers you wouldn't necessarily think of. However, as an investor, on day one, you want to be able to say to yourself, "Yeah, I can see who will buy this company and why. The next step then is to determine for how much and when."

After five-to-seven years (the typically fund life cycle), most VCs typically seek to get out 5-10x the amount they invested. This is why most institutional investors only seriously consider companies that can hit $50M+ in revenue in short order. They know that most tech acquisitions are done as a multiple of revenue. Therefore, if they have invested $5M and own 30% of the company at exit, they need to have the company selling $50M plus in product annually and still get at least a multiple of 2x on sale. This is why scaling (see item #4) into a large market (#1), is so important to venture capitalists.

Lyall, agrees with Raffa on this point. "There needs to be potential exits. There have to be companies or public shareholders who will buy the company once it's built and scaled. Ideally, there would be companies who would want to acquire the venture for strategic reasons". Hence there is the need for a strong competitive advantage (#2) Lyall corroborates this by suggesting, that "If the buyer needs that venture's product to stay in business or grow you are most likely going to get a better price for it."

Putting it all Together

As I tend to fall asleep during romantic comedies, I'm at a loss to tell you how Mel's movie ended; however, I do hope that the above has helped you peer into the mysterious minds of venture capitalists. Now all that remains is one final question: Do you need to have all five of these "prerequisites" in place before you go seeking investment?

The answer; not by a long shot. As Propulsion's Hogue states, "If you are weak in one area, it is fine, just make sure you are off the charts in the other areas to compensate." A sentiment that Accel's Effusy agrees with but puts another way: "Quite frankly, it is rare that all five of these items are present in the same company in the beginning. You typically start with one or two elements that are extraordinary and that you believe in deeply and then you have to make a leap of faith. After all that is why they call it Venture Capital".

Notwithstanding, all the parties surveyed agreed that the stronger you are in each of the 5 elements, the more likely it is that "what VCs want" will be to invest in you.

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