Aug 2, 2018, 08:16am EDT

How Venture Capital Works

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Venture capital firms are without a doubt the muscle behind innovation as they support the company they may invest in, from the early stages, all the way to IPO — especially those with larger funds that have billions of dollars under management.

Defining the Roles at a VC

As described in my book, *The Art of Startup Fundraising*, VC firms have different types of individuals working at the firm.

The most junior people want to be analysts. These people are either MBA students in an internship or people that just graduated from school. The main role of analysts is to go to conferences and to scout deals that might be within the investment strategy of the fund that the VC firm is investing out of. Analysts are not able to make decisions, but they could be a good way to get your foot in the door and to have them introduce you to someone more senior within the firm. However, analysts are for the most part conducting research of the market and studying you and your competitors, so be careful with educating them too much.

The most immediate position after the analyst is the associate. An associate could be either junior or senior. Associates tend to be people that come with a financial background and with powerful skills in building relationships. Associates do not make decisions in a firm but they can definitely warm up an introduction with individuals involved in the decision-making.

Over associates, you will be able to find principals. They are senior people that can make decisions when it comes down to investments but they do not have full power in the execution of the overall strategy of the firm. A principal can get you inside the door and be your lead to help bring you through the entire process of receiving funding. Principals are those individuals that are close to making partner. They have power within the firm but cannot be considered the most senior within the firm.

The most senior people within a VC firm are above principals, and are called partners. Partners could be general partners or managing partners. The difference in the title varies depending on whether the individual just has the voice in investment decisions or may also have a say in operational decisions. In addition to investments, partners are also accountable for raising capital for the funds that the firm will be investing with.

Lastly, venture partners are not involved in the day-to-day operations or investment decisions of the firm. Venture partners have a strategic role with the firm, mainly involving bringing new deal flow that they refer to other partners of the firm. Venture partners tend to be compensated via carry interest, which is a percentage of the returns that funds make once they cash out of investment opportunities.

Another figure in a VC firm is the entrepreneur in residence (EIR). EIRs are mainly individuals that have a good relationship with the VC and perhaps have given the VC an exit, helping them earn cash. EIRs generally work for a year or so with the firm helping them to analyze deals that come in the door. Ultimately the goal of an EIR is to launch another start-up for positive investment.

Investors of VC firms are called Limited Partners (LPs). LPs are the institutional or individual investors that have invested capital in the funds of the VC firm that they are investing off of. LPs include endowments, corporate pension funds, sovereign wealth funds, wealthy families, and funds of funds.

The Process of Getting Funded by a VC

First and foremost, identify the VC that might be investing within your vertical. There are plenty of tools you can use to identify who might be a fit. (You can use Crunchbase, Mattermark, CB Insights, or Venture Deal.)

Once you have your list of targets, you will need to see who you have in common and close to you who would be in a position to make an introduction. The best introductions come from entrepreneurs that have given good returns to the VC. VCs use these introductions as social proof and the stamp of approval on the relationship. The better the introduction is, the more chances you have of getting funded.

As a next step to receiving the introduction, and in the event there is a genuine show of interest from the VC, you will have a call. Ideally you would want to go straight to the partner to save time, or the goal would be to get an introduction to the partner ASAP. If you are already in communication with the partner after the first call, he or she will ask you to send a presentation (also known as pitch deck) if the call goes well and there is interest.

In this regard, I recently covered the pitch deck template that was created by Silicon Valley legend, Peter Thiel (see it here). I also provide a commentary on a pitch deck from an Uber competitor that has raised over $400M (see it here).

After the partner has reviewed the presentation, she will get back to you (or perhaps her assistant) in order to coordinate a time for you to go to the office and to meet face to face. During this meeting, you'll want to connect on a personal level and to see if you have things in common. The partner will ask questions. If you are able to address every concern well and the partner is satisfied then you will be invited to present to the other partners.

The partners meeting is the last step to getting to the term sheet. All the decision-making partners will be in the same room with you. Ideally the partner you have been in communication with has spoken highly of you, unless there have been issues (which you've hopefully covered by this time).

You'll receive a term sheet if you were able to satisfy the concerns put forward at the partners meeting. Remember that term sheet is just a promise to give you financing. It does not mean that you will get the capital. It is a non-binding agreement. If you want to dig deeper into term sheets I recommend reviewing the Term Sheet Template piece that I recently published on Forbes.

Following the term sheet, the due diligence process begins. It will typically take a VC one to three months to complete the due diligence. Unless there are no major red flags you should be good to go, and receive the funds in the bank once all the offering documents have been signed and executed.

Fundraising Timeline FUNDRAISING TIMELINE

How VCs Monetize

VCs make money on management fees and on carried interest. Management fees are generally a percentage of the amount of capital that they have under management. Management fees for the VC are typically around 2%.

The other side of making money is the carried interest. To understand this concept, carried interest is basically a percentage of the profits. This is normally anywhere between 20% and 25%. It is normally in the largest range if the VC is a top tier firm such as Accel, Sequoia, or Kleiner Perkins.

In order to cash out and receive the carried interest, the VC needs to have the portfolio of each one of the funds making an exit, which means that the company is acquired or will through an IPO where investors are able to sell their position.

Normally exits take between five to seven years if the company has not run out of money or the founders have run out of energy. Typically VCs want to sell their position within eight to 10 years, especially if they are early stage investors.

Start-ups are a very risky type of asset class and nine out of 10 will end up failing. For that reason, VCs will go for those companies with the potential of giving them a 10x type of return so that it can help them with the losses of other companies inside their portfolios. If you are not able to project these kinds of returns, a VC might not be the route to follow for financing.

VC Involvement with Your Company

VCs would like to have a clear involvement with your company in order to stay close to their investment and to have a say in major decisions that could impact their returns in the long run.

With this in mind, VCs will normally buy in equity between 15% to 45% of your company. Normally in earlier stage rounds, it tends to be on the higher end but VCs need to be mindful of the stake they leave with the entrepreneur so that they are still motivated enough to stick around and to continue focusing on the execution.

VCs will request board involvement in return for the investment that they are making in your company. There are two types of board levels. One will be the board of director seat in which they participate in major decisions of the company. This is especially important when it comes to future rounds of financing or merger and acquisition transactions (also called M&A).

The other level of board involvement is what is known as board observer, which means they will have an open invitation to attend meetings without a vote. In my experience they still have a lot of influence. Below is an image comparing directors vs. observers.

Board Members vs. Board Observers BOARD MEMBERS VS. BOARD OBSERVERS

Understanding the Value a VC Brings

Most VCs say the main reason why an entrepreneur should consider working with a VC is because of the value they can bring to the overall strategy and execution of the business. However, that is far from true.

You will need to do the due diligence in order to really understand if a VC is going to add value in addition to capital. This value can be introductions for potential partnerships, their network of other successful founders, or the infrastructure the firm brings.

The infrastructure could be the most attractive part. VCs like Andreessen Horowitz or First Round Capital have a dedicated team of marketers, recruiters and other resources to bring into a company they invest in. Ultimately this helps in fueling the growth of the business.

Cutting Through the VC Noise

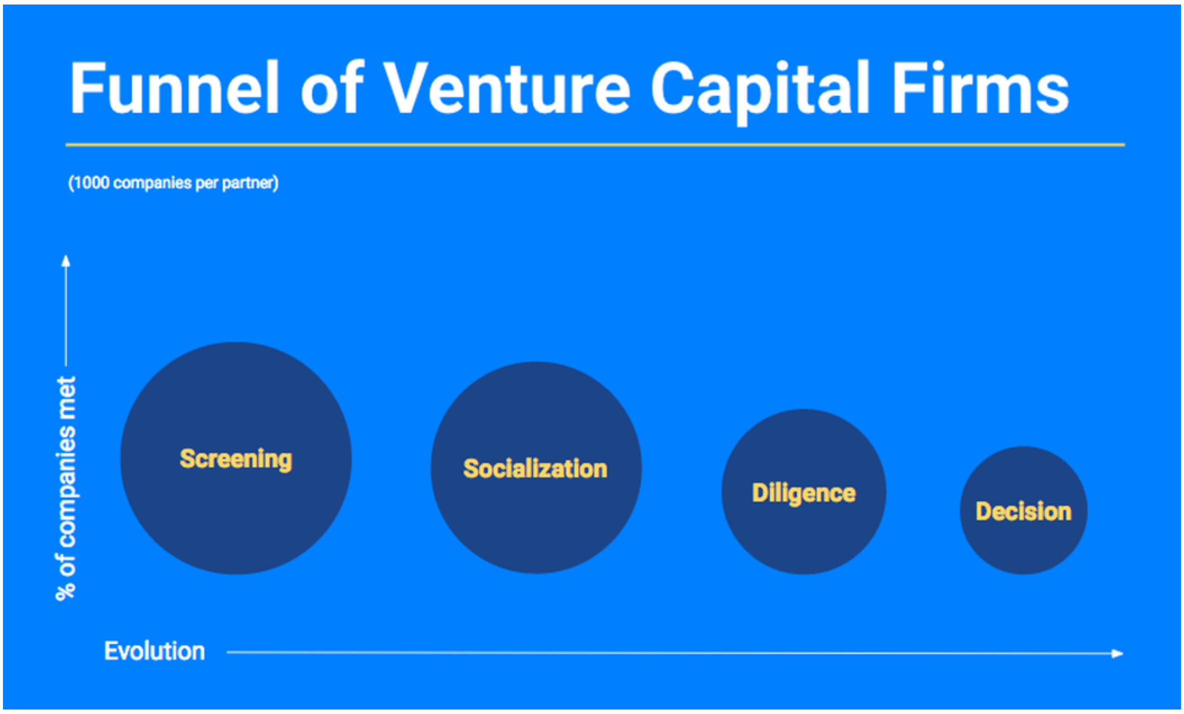
As a founder you want to ask the right questions, which will help you understand if the VC is truly interested in investing, or what style of partners you will be onboarding to your company after the financing round is closed.

If the VC firm has not invested in more than 6 months in new companies, that indicates that the VC is having trouble closing their next fund or that they are in fundraising mode. If this is the case, move on to the next VC, otherwise the process will be put on hold. Closing a fund typically can take between 12 to 24 months. You always want to choose to work quickly. If you need a list of the most active VCs I recommend reading this other piece on Forbes that I recently published.

Ask how they typically work with portfolio companies. Ask the VC to make an introduction to a few founders from companies that have gone out of business. These questions can provide a complete picture and see how they behave when they are on the other side of the mountain. During the dating phase everyone is happy without any worries so don‘t be mistaken as people change when there is money on the line.

In addition, ask about allocations to the options pool for employees of companies your size. (This should be written out in the deal's terms.) If you see they want to allocate over 20% on a seed round, or over 10% on a Series A, round of financing that could mean they may eventually want to replace the founding team.

The deal flow funnel of a VC is typically what you will find represented on the image below. On average, out of 1,000 companies a partner ends up investing in 3 to 4 of them on a yearly basis. This means that only 0.2% companies receive VC financing.



VC Funnel VC FUNNEL

Differences Between Venture Capital and Private Equity

There is confusion between these two types of investors. Venture capital firms tend to work throughout the life cycles of a company, all the way to the liquidity event, when the start-up either gets acquired or goes through an IPO.

VCs are also very much involved in the operational structure. However, the main difference is that VCs invest in people with a greater degree of risk than a traditional private equity (PE) firm. PEs will go more for the numbers. They invest in businesses that are already formed, where the outcome is more predictable.

PEs will often invest in growth stages and later rounds, so your start-up, if you are in the early stage, will most likely not be a fit. Wait until you are at a Series C or Series D round of financing before seeking funding from private equity.

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I am a serial entrepreneur and the author of the The Art of Startup Fundraising. With a foreword by ‘Shark Tank‘ star Barbara Corcoran, and published by John Wiley &... **Read More**