

FAQ on Venture Capital

1 - How is a typical VC company structured?

Venture Capital companies, generally, are composed of two entities:

-Advisory Company: this is the visible component and the one which the invested company comes in contact with. It is composed of a lean team of professionals (2-10, on average) + back-office; it manages one or more VC funds (Closed-end funds); buys and sells stakes in privately owned companies having as primary objective the maximum level of capital gain; the higher the capital gain of advised funds, the higher the level of track-record credibility and ease fund raising for new VC funds.

-Closed-end fund: it is generally the invisible component of VC; it is defined as "closed" because after fund raising (from pension funds, mutual funds, financial institutions, privates, etc.) reaches target levels, it is closed to further investments. The closed-end fund is the "war chest" that the advisory company has for its buying and selling activities during the course of the life of the fund (typically 10 years). At liquidation, 80% of the capital gain goes to the underwriters of the fund while the Advisory Company retains 20%.

2 - What are the sources of its revenues and earnings?

The Advisory Company has rights , by statute, to retain yearly up to 2-3% of total invested funds in the closed-end fund, as a management fee; the fee covers the cost of operations; hence the major source of income is the share of capital gain, 20% on average, which results from liquidation of the fund; the higher the capital gain of the fund (i.e.: better investment decisions!) the higher the return for the Advisory Company partners.

3-What level of returns VC companies have in mind?

The minimum target IRR (Internal Rate of Return) in the venture capital business is generally 40% ; it seems high, however it must be kept in mind that the rate of failure of VC investments is high: out of 120 investments on average only 2 or 3 perform and generate the total gain for the fund; hence every investment is evaluated on its perceived potential to generate a 40% compounded rate of IRR a year; there different methods to value a company and its business, but generally speaking, the starting point is the Business Plan and its economic-financial projections. In the real world the average return recorded by the VC industry is in the order of 20-25% per year.

4-Why finance with venture capital

Offers risk capital otherwise inaccessible through traditional sources

Provides a direct , fast , impartial and informed opinion on the business

Fast turnaround, especially international VC;

Provides operating support to Management in the most important decisions

Creates Network, financial, industrial and image-wise

VC if fiercely, motivated toward capital gain and this is a common objective

VC is, almost always, a MUST for Initial Public Offerings

5-Potential sources of problems with venture capital

- Hard and stringent negotiations on the value of your companies
- Costs: management time and legal/notary time
- Presence of a VC Director in your Board, and higher frequency of Board meetings

6-How do VCs define a valuation of the company in which they invest?

The starting point is the **market value of recently completed deals** with similar companies; such value reflects market conditions, hence it varies; this value, which is the market value , is confronted with the Net worth value in established companies or, as it is the case with high-tech companies, with the prospective value of the business based on earnings projections described in the Business Plan, and with the associated risks. The final starting value is a compromise among the three factors: market value, prospective value and risks. A good

knowledge of the market and of competition is the best warranty that an entrepreneurs has to obtain the highest possible valuation for its company with venture

7-Future revenues and earnings in the BP: aggressive, realistic or conservative

Conservative , as one would with plans developed for internal purposes

But highlighting properly events and conditions that could generate substantial upsides

8-And what about costs and investments?

Prepare for the worst!, is the key word!

Adopt conservative parameters for whatever you can adequately predict in terms of ordinary and extraordinary management items; be prepared with emergency plans for events which have a low but potentially destructive impact on your business , cost-wise or investment-wise.

9-Is it necessary to define upfront how much money my company needs?

YES! The total cash needs of your company emerge for the Sources and Uses analysis in your business plan; ask for what is necessary, taking into account uncertainties, but , no more, no less! Do not forget that Venture capital can be very expensive equity-wise.

10-Is it better to seek national or international VC ?

In Europe, the situation varies from country to country; in the UK , where there is a strong VC sector it would be an irrelevant question; more or less the same would be in all other countries where there is a well established VC industry (Northern Europe). The question is very relevant in the Mediterranean countries of EU where the tradition of VC is young; the answer, in these countries, would be that, if the deal involves a well established company with an adequate revenue base, then going national is definitely a choice; if, instead, the deal is a high-tech one (Internet, Biotech deal) your chances are better off with an international VC company that has investment experience in these areas; at least to obtain a preliminary feedback on your offer.