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VENTURE CAPITAL

Maximize VC evaluations in uncertain market

Text by SUSAN PRAVDA

Today's financial market might seem unsteady, but investors and entrepreneurs remain optimistic, albeit less bullish and more realistic. Capital is still being raised. Venture capital funds continue to grow, and as deal size continues to increase, a new breed of early stage investors has emerged to fill the resultant funding gap.

That's good news for entrepreneurs seeking seed capital.

There is some slowdown, however. The market for mergers and acquisitions has decreased and high valuation exit strategies have become harder to find, as the initial public offering (IPO) market has cooled its pace.

Despite Visa's success as the largest ever IPO in the U.S., the slowing IPO market might cause investors and entrepreneurs some anxiety – even though the technology industry is prone to boom and bust cycles.

Can the market ride out the bust? In an effort to answer this question, Foley & Lardner surveyed 215 female and male founders, executives, advisors and investors in the emerging technology industries last November. This study provides a follow-up to data collected by the firm in 2006 and 2005.

Respondents of both sexes to the 2007 survey suggest that the credit crunch has not had a major impact on the emerging technologies market. In fact, investors suggest that

they have suffered only minimal damage.

For example, 85 percent of investors believe the crunch has had no effect on their ability to fund transactions, and 77 percent believe it has had no effect on the perceived valuation of their companies.

Alongside this optimism, there are signs of more cautious behavior. Although 84 percent of investors believe that the credit crunch has not affected their fundraising timelines, more investors are lengthening them from within one year to within two years as compared to data from 2006.

The number of investors indicating that they will not raise a new fund has increased from 5 percent of investors surveyed in 2006 to 15 percent of investors surveyed in 2007.

So, while the majority of investors remain optimistic, this optimistic majority is smaller than it has been in years past.

The optimism doesn't extend to every industry. None of the company executives surveyed expected that the retail industry would present an opportunity for success within the next two years and 48 percent identified retail as the business area with the worst outlook. The manufacturing industry got a similar report.

It is worth noting that 47 percent of company executives reported optimism about opportunities in the biotech industry, but only 15 percent of investors surveyed indicated that they might focus their dollars there in 2008 and 2009.

The outlook remains promising for the technology arena. Consistent with 2006, 65 percent of investors expect to focus most of their investment dollars in 2008 and 2009 on software and IT.

And 43 percent of emerging company executives identified software/IT as presenting the best opportunity for entrepreneurial success.

Investors are cautious in a time of uncertainty, but the opportunities are still there. Truly exceptional emerging technologies and businesses will continue to find the capital they need.

In Boston, where the venture capital market is particularly efficient, it's critical that an entrepreneur make the right first move toward a venture

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capital fund.

How best can entrepreneurs exploit the current market conditions and investor expectations to get a maximum valuation on a new idea or technology?

1. Prepare a clear and articulate value proposition. An idea that cannot be clearly and concisely explained cannot be funded.

2. Consider all options. Venture capital firms are increasingly focused on funding larger deals. Alternative sources of equity – angels or high net worth individuals, for example – could be a more appropriate source of seed capital for an early-stage product or idea.

3. Know the audience. Venture capital firms conduct extensive due diligence on potential investments, and an entrepreneur would be wise to take the same approach with their investors. Research into portfolio company technologies, as well as past investment patterns, can offer insight into how an entrepreneur might deliver a more effective pitch for a higher valuation.

4. Make strategic connections. It's not what you know, it's who you know. An entrepreneur who gains access to a venture capitalist through a portfolio company or past investment representative might be more warmly received than one who arrives cold. Also, strategic industry connections can build strong management – and investor confidence.

5. Plan to subsist on minimal capital. More than half the respondents to the 2007 survey said that companies need to survive on less capital than they did 10 years ago. Founders must demonstrate a willingness to sacrifice short-term luxuries and financial gains for the sake of product development.

6. Demonstrate an ability to innovate. Respondents suggest that the determinant to a successful company is innovation. The ability to adapt to uncertain market conditions is critical. This might require consideration of the alternative applications of a technology or alternative market strategies.

7. Understand and defend a market position. The market need for the product must be demonstrated, and it must be explained how market share will be maintained in the long term.

This may involve consideration of an intellectual property (IP) protection strategy. It might also involve consideration of exit possibilities.

The current IPO market is lagging, and only 56 percent of emerging company executives surveyed cited a merger or sale as a likely exit strategy, a decrease from earlier years.

But it is still important that entrepreneurs conduct due diligence into market transactions to get a sense of what potential buyers or partners might exist.

A more cautious market means more work for the entrepreneurs seeking funds – investors will want to see more evidence of potential success and more careful consideration of partnership and exit opportunities.

Securing venture capital is challenging, but today's market does offer more alternative funding sources for early stage start-ups, and it continues to offer opportunity to entrepreneurs in the emerging technologies who have done their careful homework.

More preparation and due diligence upfront will translate into a better valuation for a technology start-up.

Susan E. Pravda is office managing partner of the Boston office of Foley & Lardner and chair of the emerging technologies team.