6-1-1988

Venture Capital Speech

Duane Pearsall

Follow this and additional works at: http://digitalcommons.wpi.edu/ms055-03-0017

Part of the Entrepreneurial and Small Business Operations Commons

Recommended Citation
Retrieved from: http://digitalcommons.wpi.edu/ms055-03-0017/13

This Other is brought to you for free and open access by the MS055.03 Small Business Records at DigitalCommons@WPI. It has been accepted for inclusion in MS055-03-0017 Speeches by Duane Pearsall by an authorized administrator of DigitalCommons@WPI. For more information, please contact jcolati@wpi.edu.
VENTURE CAPITAL

For the next fifteen minutes, let me give you an overall view of the venture capital industry, where it might apply to some companies and not to others.

Slide one - Columbine Venture Fund, Ltd., Denver, Colorado "A Venture Capital Partnership investing in early stage technology-based businesses".

Note the strategy of our fund is early-stage and technology-based (not necessarily high technology) businesses. Different venture capital funds have different objectives, some are marketing oriented and low technology, some are later stage investors. Very few focus on seed level investments which will be explained later.

Slide two - This is a more specific profile of our fund. Later we will identify different types of funds with different strategies.

Slide three - Note that our investment strategy includes seed level, start-up and first round financings. We expect about half of our investments or more will be located in the lower four states of the mountain states. Areas of technology are somewhat related to the backgrounds or interest of the partners. Because one of our partners, Terry Winters, is a PhD in Chemistry and very knowledgeable about the state-of-the-art in the biotechnology - genetics arena, our fund is a little unusual to have a strong biotechnology focus.

Although we will be the lead investor in those companies that are located in our target area and in which we may be the first investor, we encourage other venture funds to co-invest with us. In turn, we respond to the requests for investment as a co-investor with funds located outside of our territory where we will not take a board seat, but will remain as an observer with essentially all rights of the board of directors except the liability.

I have mentioned Terry Winters as one of my partners. The other two are Mark Kimmel and Sherman Muller. Mark Kimmel had a great deal of experience in new ventures at 3M and later in business development at Motorola. Sherman Muller went immediately into an SBIC venture capital arm of a bank in Baton Rouge, Louisiana following his MBA from Tulane. Mark formed an SBIC, Enervest in 1977 and encouraged Sherman Muller to join him in 1979. The fund was liquidated in 1984. With 22 portfolio investments it returned to the investors a 30% return on investment internally compounded.
Slide four - Note that unlike commercial lending or typical private financing, the professional venture capitalist considers himself in the business of building businesses in many cases it is this hands on assistance from the venture capitalist that keeps the company focused and helps the entrepreneur in its growth.

Slide five - Note the source of funds essentially from pension funds, insurance companies, U.S. corporations, foreign sources and one percent from the general partners that capital is then invested in partnerships such as ours, SBIC's, a program of the SBA and corporate groups. We then make investments in companies we consider high growth that fit our strategy and profile. As we are able to liquidate our asset in those companies, the money flows through our partnership directly back to the source of funds or the initial investors. In our case, we do not roll over investments and we are a ten year limited partnership with a ten year life. The pool of venture capital funds has grown from about $100 million in 1974 to approximately $18 billion ending 1985.

Slide six - Here is a graphic representation of where venture investments have gone in the year 1983. By 1985, as you might imagine, computers are reduced somewhat but it still remains one of the major areas of interest.

Slide seven - This chart is particularly important if you want to assess the judgement of venture capitalists. Note that the 15% total loss when added to the 25% partial loss suggests that venture capitalist make mistakes in 40% of their investments. Also note that when a company is evaluated, the venture capitalist will not make an investment unless he believes firmly that he has the opportunity of returning 10 times his investment or more in a period of five to ten years. One might also keep in mind that the maximum loss an investor can have is his total investment. The upside, however, may be as high as 30, 40, or 50 times the investment and it is that underlying numbers balance that allows the venture capital industry to have established such an enviable record of an average of 25% return on investment internally compounded.

Slide eight - Now we get to the decision process and what we need to consider in our evaluation of a potential portfolio investment.

The quality of management cannot be overemphasized. We look for that characteristic of entrepreneurship. A start-up company needs a very strong and very committed management if it is to survive.
Down the list in terms of priority is the competitive advantage, the growth prospects for the company, the size of the marketplace, the quality of the business plan and their ability to implement that plan. Finally, we need to know that at some time in the success of that company the venture capital investment can be liquidated. In today's environment 95% of all our liquidations are by the route of acquisition by a major corporation. A public offering is only considered if the company has reached a level of maturity that can assure its future continued return to public investors.

Slide nine - On the subject of pricing and valuation, is it often asked how do we address that problem. First, we are minority investors. From our experience we can reasonably assess the valuation. Note that this is not a matter of formulas. At least we have not found a formula that is anywhere near valid. For instance, if we believe a company's value is in the neighborhood of $1,000,000, then for $100,000 we should purchase 10% of the equity. As an initial investment, it is highly unlikely that we would be willing to risk more than approximately $200,000 in a company valued at $1,000,000. In other words we probably would not look to be more than a 20% owner, initially and would rarely exceed 50%.

Item number 4 in that list is one we are very serious about, that is, making sure that management is a significant owner and secondly that there are sufficient options to be a major incentive to key management personnel.

Financing size also depends on the size of the investor's fund as well as the cash flow needs of the company.

We insist that a majority of the board of directors be from outside the company. We also need to be able to estimate the need for additional capital at a later stage of their development and be prepared to participate. If we have been invited to be a co-investor in a company not in our territory, we need to assess the other investors and whether or not we can be compatible with their objectives and vice versa.

Slide ten - Note that the seed level is clearly the most risky. There is no management in place, there is nothing but an idea and a judgement on whether the product is marketable. Start-up level, of course, is the next most risky since no sales have yet been made.

It would be very unusual if we would have any interest in an investment beyond the third stage. Certain funds specialize in bridge financing in order to carry companies through the costs of initiating the public offering. Other funds may focus on leverage buyouts as a specialty.
Slide eleven - Similar to the example I gave earlier, this is a circumstance where venture financing of $100,000 buys 10% of an estimated $1,000,000 valuation company. Note that the original founders have an estimated investment of $45,000, and at this very seed level stage they have, on paper, a multiple on their investment of 20:1.

Slide twelve - Note that at the first round the investors have decided that valuation of the company at this stage is $3.5 million to justify $2.00 per share or $1.5 million dollars in this case, buys 43% of the company. At this point the founders have been diluted down to 51% ownership but they are now into the millionaire category, at least on paper.

Slide thirteen - At this stage of development, the company is of a size that encourages institutional investors. It is most likely that most of the original seed and first round investors would also participate in this round, which at this stage is now priced at $7.00 per share with an estimated valuation of $15 million dollars for which they purchase 20% of the company for $3 million dollars. Again the founders have reinforced their millionaire status at a 140:1 multiple.

Slide fourteen - Finally, the company has matured to where it can insure a continued return to the public investor and the valuation has been placed at $50 million dollars, allowing 25% of the company to be sold for $12.5 million dollars. Note that if a major corporation were to acquire the company instead of going the route of a public offering, it is likely that the multiple would not be materially different.

Slide fifteen - I will not dwell on this slide to any extent since there is a seminar scheduled for next Tuesday, March 18, on this subject of developing and utilizing a business plan. One of my partners, Sherman Muller will represent venture capital in that discussion of what are the necessary ingredients to a good business plan. I would encourage your participation. Sherman is an interesting speaker noted for his blunt comments and informality. Although he is only 32 years old, I consider him a mentor to me in this venture business. Brochures for next Tuesday's seminar are located in the back of the room and I urge you to take one with you.

In summary, I want to leave a clear impression that venture capital is not for every company. We will review 100 companies before we select two or three. Do not approach a venture capitalist without a complete business plan. Next Tuesday you will find from Sherman Muller some advice on how to get the attention of a venture capitalist.
Most important, most businesses are clearly not candidates for venture capital and do not have the potential of a $50 million dollar company in 5 to 10 years nor a return of 10:1 on the investment. That does not mean they are not good companies. You should understand that venture capitalists are not investors in nice little companies. They could spend their lifetime working with a company without the return on investment potential sufficient to meet the requirements of the institutions investing in our fund.

I would finally like to leave you with the thought that the venture capital process in the United States is extremely important to the future of this country. From my view of the technologies still unexposed in some of the high tech companies in this country, it is easy to predict that life expectancy will continue to increase, microchips will continue to change our lives even more dramatically and there is still an opportunity for another Apple computer.

Fortunately, the venture capital process is unique to the United States and may be considered one of our strongest economic weapons. Take Japan, for example. In that country each individual is taught diligence and loyalty. When he or she takes their first job, historically it has been for life. In the United States, the venture capital process is driven by entrepreneurs. Entrepreneurs who may have developed an idea while employed by a major high tech company, decide that he or she might grab a piece of the great American dream, leave their company, put a new company together and may ultimately become a big winner using the venture capital process.

On the other side of the world in Switzerland and Germany for instance, it is a disgrace to fail in business. Therefore, the risk of entrepreneurship is higher and there are fewer participants.

Small business is noted for its creativity. National statistics show that small business can produce a product in three fourths the time and one fifth the cost of a large business.

Venture capital is an exciting business simply because we have a front row seat watching entrepreneurs with brilliant ideas together with their energy and enthusiasm to make big things happen.
COLUMBINE VENTURE FUND, LTD.
DENVER, COLORADO

A VENTURE CAPITAL PARTNERSHIP INVESTING IN EARLY STAGE TECHNOLOGY-BASED BUSINESSES
COLUMBINE PROFILE

- $85.5 MILLION CAPITAL
- FORMED JUNE 1984, TEN-YEAR TERM
- FOUR GENERAL PARTNERS
- 51 LIMITED PARTNERS (INTERNATIONAL)
- EIGHT MEMBER ADVISORY BOARD
- BUSINESS DEVELOPMENT SPECIALISTS
- ACTIVE INVESTORS
- INVESTMENT SIZE:
  - $200,0000-600,000 INITIAL
  - $3.4 MILLION MAX
  - $50,000 MIN. (SEED)
INVESTMENT STRATEGY

- EARLY STAGE (SEED, START-UP, 1ST ROUND)
- ROCKY MOUNTAIN FOCUS - INVEST NATIONWIDE
- TECHNOLOGY
  - MEDICAL
  - BIOTECHNOLOGY/MATERIALS
  - COMPUTERS/COMMUNICATIONS
  - ELECTRONICS
- LEAD INVESTOR IN MOST DEALS
- BOARD MEMBER
- HANDS-ON ASSISTANCE
  - SEED PROGRAM
- FUND GOALS
  - 40 INVESTMENTS IN FOUR YEARS
  - 30X COMPOUNDED I.O.I.
VENTURE CAPITAL

"BUSINESS OF BUILDING BUSINESSES"

"FINANCING SMALL COMPANIES IN RETURN FOR EQUITY"

"PRIVATE EQUITY FINANCING OF SMALL COMPANIES WHERE THE INVESTOR GIVES HANDS-ON ASSISTANCE TO GROW THE COMPANY"
VENTURE INVESTMENTS - 1983
BY INDUSTRY
COMMUNICATIONS
ELECTRONICS
MEDICAL
CONSUMER
ENERGY
OTHER

DE 52'48
DISTRIBUTION OF TYPICAL PORTFOLIO
GAINS & LOSSES

- 1-2 TIMES: 30%
- 2-5 TIMES: 20%
- 5-10 TIMES OR GREATER: 15%
- TOTAL LOSS: 5%
- PARTIAL LOSS: 10%
KEY INVESTMENT CRITERIA

- Quality of Management
- Competitive Advantage
- Growth Prospects
- Business Plan and Implementation
- Exit
OTHER INVESTMENT CRITERIA

- Pricing/Valuation
- Compatibility of Goals
- Location/Accessibility/Effort
- Significant Ownership for Management
- Financing Size
- Board Position/Majority Outside Board
- Reasonable Long Term Capital Needs
- Familiarity With Industry
- For Participation
  - Previous Strong Investors
  - Capable Lead Investor
<table>
<thead>
<tr>
<th>LIFE CYCLE</th>
<th>VERSION A</th>
<th>ROUGH #22</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEED</td>
<td>TO DEVELOP CONCEPT</td>
<td></td>
</tr>
<tr>
<td>START-UP</td>
<td>DEVELOP PRODUCT</td>
<td></td>
</tr>
<tr>
<td>FIRST STAGE</td>
<td>BEGIN SELLING</td>
<td></td>
</tr>
<tr>
<td>SECOND STAGE</td>
<td>SALES, NOT YET PROFITABLE</td>
<td></td>
</tr>
<tr>
<td>THIRD STAGE</td>
<td>PROFITABLE NEED TO EXPAND</td>
<td></td>
</tr>
<tr>
<td>BRIDGE OR MEZZANINE</td>
<td>PRIOR TO PUBLIC OFFERING</td>
<td></td>
</tr>
<tr>
<td>TURN AROUND</td>
<td>SURGERY ON SICK COMPANY</td>
<td></td>
</tr>
<tr>
<td>LEVERAGED BUY-OUT</td>
<td>BORROW AGAINST ASSETS TO BUY PROFITABLE COMPANY</td>
<td></td>
</tr>
<tr>
<td>PUBLIC</td>
<td>BUY PUBLIC SHARES</td>
<td></td>
</tr>
</tbody>
</table>
**SEED FINANCING OF $100,000, VALUATION OF $1,000,000**

<table>
<thead>
<tr>
<th>OWNERSHIP</th>
<th>PRICE PER SHARE ($)</th>
<th>INVESTMENT ($)</th>
<th>MULTIPLE</th>
</tr>
</thead>
<tbody>
<tr>
<td>FOUNDERS</td>
<td>90</td>
<td>0.05</td>
<td>450,000</td>
</tr>
<tr>
<td>INVESTORS  (SEED)</td>
<td>10</td>
<td>1.00</td>
<td>100,000</td>
</tr>
</tbody>
</table>
FIRST ROUND FINANCING OF $1,500,000
VALUATION OF $3,500,000

<table>
<thead>
<tr>
<th>Ownership</th>
<th>Price Per Share ($)</th>
<th>Investment ($)</th>
<th>Founders Multiple</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founders</td>
<td>51</td>
<td>0.05</td>
<td>45,000</td>
</tr>
<tr>
<td>Investors (Seed)</td>
<td>6</td>
<td>1.00</td>
<td>100,000</td>
</tr>
<tr>
<td>Investors (First)</td>
<td>43</td>
<td>2.00</td>
<td>1,500,000</td>
</tr>
</tbody>
</table>
SECOND ROUND FINANCING OF $5,000,000
VALUATION OF $15,000,000

<table>
<thead>
<tr>
<th>OWNERSHIP</th>
<th>PRICE PER SHARE ($)</th>
<th>INVESTMENT ($)</th>
<th>FOUNDERS MULTIPLE</th>
</tr>
</thead>
<tbody>
<tr>
<td>FOUNDERS</td>
<td>41</td>
<td>.05</td>
<td>45,000</td>
</tr>
<tr>
<td>INVESTORS (SEED)</td>
<td>5</td>
<td>1.00</td>
<td>100,000</td>
</tr>
<tr>
<td>INVESTORS (FIRST)</td>
<td>34</td>
<td>2.00</td>
<td>1,500,000</td>
</tr>
<tr>
<td>INVESTORS (INST.)</td>
<td>20</td>
<td>.70</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

DE 52422
J-JM
PUBLIC FINANCING OF $10,000,000
VALUATION OF $50,000,000

<table>
<thead>
<tr>
<th>Ownership (%)</th>
<th>Price Per Share ($)</th>
<th>Investment ($)</th>
<th>Founders' Multiple</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founders</td>
<td>3.1</td>
<td>.05</td>
<td>45,000</td>
</tr>
<tr>
<td>Investors (Seed)</td>
<td>3</td>
<td>1.00</td>
<td>100,000</td>
</tr>
<tr>
<td>Investors (First)</td>
<td>26</td>
<td>2.00</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Investors (Inst.)</td>
<td>15</td>
<td>7.00</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Public</td>
<td>25</td>
<td>17.00</td>
<td>12,500,000</td>
</tr>
</tbody>
</table>
BUSINESS PLAN INGREDIENTS

- EXECUTIVE SUMMARY
- COMPANY HISTORY AND BUSINESS
- PRODUCT/TECHNOLOGY
- MARKET ASSESSMENT
- SALES AND MARKETING PROGRAM
- COMPETITIVE EVALUATION
- EQUITY CAPITAL NEEDS
- EXISTING CAPITAL STRUCTURE
- FINANCIAL PROJECTIONS
- P&L AND BALANCE SHEET
- DETAILED RESUMES OF MANAGEMENT