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Five venture capital lessons for SMEs

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Abstract:

Venture capital financing is complex and often misunderstood area of business. After 25 years of working in the VC industry the author outlines five key lessons for those seeking to acquire equity from professional venture financiers. First, the business must offer a sustainable competitive advantage. Second, it is critically important to keep costs down and cash flow positive. Third, those seeking VC funding must learn how the game works. It is a staged process and requires a dilution of original owners' equity. Fourth, the growth of a business takes place in stages and a different type of management team will be needed for each stage. Finally, the portfolio of what is put under investment will yield only a few "golden rings" and knowing how to spot them is not easy.

Keywords: Venture capital, SMEs, sustainable competitive advantage, business plans

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INTRODUCTION

If you go to my LinkedIn profile you will see I worked some 25 years as an entrepreneur and venture capitalist. I raised nearly \$200 million for five funds and successfully grew companies that made significant capital gains for their owners including DKS (MD 1989-91), GMD Group, IPL Datron, Scitec (Chairman 1994-2000) , Neverfail SpringWater (Chairman 1990-95) and VeCommerce (Chairman 2000-2006). My book *Enterprise and Venture Capital - A Business Builders' and Investors' Handbook* (Allen & Unwin) sold over 15,000 copies across five editions and for a time was the handbook of the Australian Venture Capital industry. I was once asked to summarise my career and I replied "5000 Business Plans, 50 deals, 25 write-offs." Bill Gates famously said "It's fine to celebrate success but it is more important to heed the lessons of failure." So in that spirit I would like to relate five lessons that I have learned that would be helpful to SME owners.

LESSON #1: DOES YOUR BUSINESS HAVE A SUSTAINABLE COMPETITIVE ADVANTAGE (SCA)?

This message was rammed home to me when after graduating from Cambridge in 1967, and working for two years at IBM in the most boring place in England, namely Welwyn Garden City, I joined a brand new start-up computer bureau as the systems programmer based in Oxford Circus, the centre of swinging London in the 1960s. I was one happy bachelor.

Computer Time International Limited (CTIL) had previously been a broker, matching selling the computer time of clients who had dead night shifts due to excess computer capacity to those who were short of computer time. In particular they had four major clients each buying around 40 hours per week. The owners came up with the idea that instead of renting time, they could rent their own computer from IBM. Accordingly they rented what was at the time the largest 360 processor in the UK, a 512kb IBM 360/50.

Unfortunately only two of their clients came across; the other two contacting the appropriate counter-party directly and striking a direct deal. After nine months CTIL collapsed with the usual explanation of undercapitalisation. However I now realise, with hindsight, CTIL was never going to work as Moore's Law meant that whatever happened raw computer time would get inherently cheaper every year. A simple lesson yes but you would be amazed at how few business plans I have seen that have a true SCA. Also how few entrepreneurs know how to create an SCA.

For example on page 25 of my book I describe how a struggling Sydney CBD printer has a wonderful SCA in two city parking spots. As soon as the owner and production manager were convinced by an irate investor advised by yours truly to commute by rail instead of by car, and sent out flyers publicising the easy access to their printing business boomed. People forget how heavy printed documents are.

Within two years of Neverfail SpringWater starting it had over 40 competitors. Everyone else talked about their pure water. We realised that once we had grabbed a location, customers would not change suppliers and hence the battle was get market share early. The SCA of Neverfail was the location of water cooler. So we focused on free trails, commissions to the drivers who could sign up neighbouring offices etc.

Jack Welch has a saying that every budding entrepreneur should never forget:

“If you don’t have a competitive advantage, don’t compete.”

LESSON #2: LEASE THE PENCILS

My first attempt at working at a start-up had collapsed after nine months and I was on the street. The message ringing in my ears was that Computer Time International Limited (CTIL) had failed because it was undercapitalised. While this was unfortunately untrue I had not yet had enough business experience to realise this. So whatever happened I was going to work for a company that had capital. A week later I was being interviewed for the dream job. The company was Dialog International Limited and I was going to join its UK subsidiary. Dialog had been formed a group of executives working for General Electric Time Sharing in the USA and UK. GE Timesharing was leading computer time sharing operator. The system used Honeywell computers but Dialog was going to use a timesharing system based on IBM computers with software developed at the University of Pittsburgh. I was going to go to the US learn the system and then return to the UK and be the systems programmer. Remember this was 1966, Dialog had raised \$4m in equity and had a \$4m credit line worth over \$40 million in today’s money. This was serious money and capitalisation was not a problem.

Before I left I was asked by the UK executives to send them a fortnightly report. The USA offices were on Long Island Sound at Milford Connecticut and within days I had organised a rental at a beach house where we subsequently had some great parties. After being shown around the palatial head office I was then sent to the operational offices some 5 miles away where the computers and software staff were located. I set myself the first task of writing a program that showed over the past 24 hours how many people were logged in, how many were programmers and how many were customers. The maximum number of users was around 100, two were customers and the rest were internal programmers. I then asked why we had so many programmers and I was told that in order to compete with GE, Dialog needed to develop a suite of financial applications. I then decided I should try and work out the costs of the organisation and I did this by the famous method of seducing the CEO’s secretary. She let slip certain key numbers over several dinners.

I will never forget my first memo to the UK executives. It began “You bastards...” What I had done was create a monthly cash flow model in BASIC (remember spreadsheets had not yet been invented) and projected that \$8 million would be consumed in around 10 months. I finished by saying that while this was unfortunate I had signed a six month lease on the beach house and I looked forward to an enjoyable summer on Long Island. And also could I please have an open return air ticket?

And so it came to pass. Dialog collapsed within 10 months. Poor control of cash is a mistake repeated again and again, particularly by start-ups founded by management who have only worked for multinationals. Typically cash collection and payables are done centrally and many MNC managers only have an understanding of revenues, profits and budgets. Cash is something that head office does. Also the perks of the MNC manager, business class travel, entertainment allowances, expensive furniture and fittings, luxury cars are all anathema to the start-up yet MNC managers cannot survive without them. *Never forget that while money may talk, cash screams.*

LESSON #3: KNOW THE GAME

It was 1986 and I was making my first visit to Silicon Valley after having raised my first VC fund, BT Innovation Limited 2 years earlier. The first day a VC looking to attract money into his own funds from our parent bank took me to three of his fund's investments. All three meetings were the same, even though the businesses were completely different. Instead of the usual tour of the factory, we were whisked into the offices of the CFO where we were given a 30 minute presentation. After the usual introductory slides of business definition, mission and vision the next slide was the funding history of the company. Typically the presentation went like this:

- The company was founded four years ago with seed capital of \$100,000.
- We got a government grant of \$500,000 nominally valuing the company at \$600,000.
- Angels put in \$500,000 three years ago for one-third of the company valuing it at \$1.5 million.
- Our first VC put in a million for 25% of the company valuing it \$4million two years ago.
- Last year another 3 VCs put in a million each for 20% of the company valuing it at \$15 million.
- Next year the plan is to IPO the business raising \$10 million for 20% valuing the company at \$50 million.

Now coming from Sydney I had never heard a presentation like this. And suddenly I heard the same presentation three times in one day. I remember saying to myself that something different is going on here.

Over the next week I managed to secure appointments with five of the top ten VCs in the valley. My approach was simple: "I have flow 15 hours to get here, surely you can spare 30 minutes?" All the VCs were curious to speak with someone who had actually done a 15 hour flight. Anyway the key question that got them talking was "Tell me what has been your best deal?" This question is the equivalent of asking someone why you are so good. My experience has always been that this usually results in a long answer.

Again the answers were unusual:

- VC1: "I have 3% of Tandem." (Tandem was the non-stop, fault tolerant computer system at the heart of all the ATM networks being build and brilliantly successful)
- VC2: "I have 3% of Tandem"
- VC3: "I have 3% of Tandem"
- VC4: "I have 3% of Tandem"
- VC5: "I have 3% of Tandem"

Finally at VC5, I asked a follow-up question "Why does every VC in the valley have 3% of Tandem. I have never forgotten his reply.

"Son, how long have you been in VC?" "Two years," I replied.

"How many deals have you done?" "Five," I said rather proudly.

"Well son, you should leave the industry because it obvious you have not got a cotton-picking clue what VC is about. Only a fool would ask a question like that."

Fortunately, he took pity on me and explained *The Game*. Understanding this model is what VC investing is all about.

First of all, fund raising is done in stages: Over a five year period a typical fund raising would go like this.

- Year 1: The company is founded with seed capital of \$100,000,
- Year 2 Angels put in \$500,000 for one-third of the company valuing it at \$1.5 million.
- Year 3 VC investor 1 puts in a million for 25% of the company valuing it \$4 million.
- Year 4 Another 3 VCs put in a million each for 20% of the company valuing it at \$15 million.
- Year 5 The company does an IPO the business raising \$10 million for 20% valuing the company at \$50 million.

The key number is the equity dilution factor. This is what percentage equity that owned by the previous holder of equity. In the first round for example it is 67%, in the next round it is 75%, 80% in year 4 and 80% in year 5.

So for the founders the amount they hold at the IPO is $100\% \times 67\% \times 75\% \times 80\% \times 80\%$ or 32%.

VC 1 holds 16%. The angels hold also hold 16%.

What happens (hopefully) is that:

1. For each round the valuation rises.
2. The founders raise new capital from new investors. If one investor ends up with a majority stake, the entrepreneurs become employees.
3. The current shareholders with a new capital raising, get diluted but hopefully the increase in valuation more than compensates.

Suddenly I had a moment of epiphany and now understood why everyone had 3% of Tandem. Subsequent capital raisings had diluted the original VC investors to the same level as the final VC investors.

This model is easily worked out on a spreadsheet and I regard it as the acid test of the entrepreneur. When he or she sits down at the computer and starts working out possible shareholdings with future raisings, I know my investment is potentially safe. Only the does the entrepreneur understand the Game. In my 25 years as a VC, I met some 5000 Australian entrepreneurs, yet only about two dozen understood the Game.

LESSON #4: WHAT STAGE ENTREPRENEUR ARE YOU?

This concept was first enunciated to me by Steven Gilbert, who is the founder of Gilbert Global Equity Partners and formerly worked with George Soros as his Deputy Investment Manager. I met him at an Annual Australian Venture Capital Conference.

According to Steven there are three stages in the life of a business and the entrepreneur needs to transform himself as the business grows.

Stage I is the Start-Up stage

During the start-up the entrepreneur has to come up with the idea and start the business. Passion and drive are very important. The entrepreneur has to be commercially astute and a good salesperson in order to raise the first rounds of finance and getting the first customers. Also he must watch the cash flow and be careful of not gold plating the product. He needs a fierce eye for detail.

Stage II is the Growth Stage

During this stage the entrepreneur starts to establish their brand identity and generate brand loyalty within their customer base. Much time needs to be spent with the core customers, modifying both the marketing and the product engineering. The growth phase is thus marked by increased sales, rise in profit margins and thus establishment of the brand name in the market. As the business expands the entrepreneur needs to recruit a team to handle the increased requirements of product development, manufacturing, operations, administration and finance.

Stage III Maturity

Now the task of the entrepreneur is to manage the far flung empire. The task becomes one of replacing managers who are unable to grow with the business, maintaining a culture of innovation and moving to a position where sales and marketing are delegated but the entrepreneur becomes the face of the company to both to its customers and shareholders.

These stages are well known. However the insight that Gilbert provided was that one entrepreneur in a thousand, such as Bill Gates could manage all three stages. The problem with entrepreneurs was that the other 999 were absolutely convinced they could manage all three as well. The secret was to ensure that the entrepreneur matched the stage of the business.

For example one of the first businesses we backed at Nanyang Ventures had as its original CEO, Andrew Demetriou who was very impressive. Andrew was the CEO of the Australian Football League, Australia's largest sports organisation, and he was brilliantly successful. He is one of the best managers of a Stage III organisation in Australia. However as the CEO of a start-up he could be best described as needing replacement. When we started looking at who had been our successful entrepreneurs at Stage I we realised that they needed a driving passion and fierce eye for detail along with commercial astuteness. They did not really need people skills. Andrew is very commercially astute but his people skills far outweigh his eye for detail.

It was a great lesson for all of us.

Lesson 5 Grab the Golden Ring

One evening we were sitting around the dinner table and the talk turned to what was the biggest deal that we had missed in our life. I started the discussion rolling by saying mine was in the early 1970s when after graduating from London Business School and working two years in Sydney I was head hunted to work in Melbourne. On arrival I contacted an LBS colleague who asked what I was doing on Sunday. Nothing I replied which is why I ringing you. He said that several of the LBS cohort based in Melbourne were helping Tony and Maureen Wheeler repack and send a book they just

written out to the bookshops on Sunday morning and then we would have a BBQ lunch. I accepted the invitation and for several Sundays helped pack the books. During the lunch the same theme was repeated. All the rest of us had jobs with major corporations and we tried to persuade Tony to emulate us. How wrong we were for this was the birth of Lonely Planet. Subsequently and much later I said to Tony that if I had offered him \$10,000 for 10% at that time would he have accepted? "With undisguised alacrity as we were broke at the time."

Gordon Bell then told us his story. Gordon was the second computer engineer hired by DEC, had become head of DEC's R&D, and was regarded as the father of the mini-computer. In the early 1980s he approached Ken Olsen, the CEO of DEC, with the idea of developing a micro-computer. Ken asked, "Who would use it?" Gordon replied, "Maybe in homes?" Olsen hit the roof, "That is the dumbest idea I have ever heard. If I hear that one dollar of DEC's R&D budget is spent on the micro-computer, I will fire you." To get this into perspective, based on the mini-computer, DEC had usurped IBM as the key computer company and Ken Olsen had been declared by Fortune magazine the entrepreneur of the century. Not the decade, but the century. Thwarted, Gordon left DEC and went to Silicon Valley and DEC subsequently lost its primacy in the computer industry.

Sheridan Bell looked at us both despairingly and told her story. She was working for DEC, in charge of internet marketing. DEC had a product called Altavista and she had heard of a start-up in Silicon Valley called Yahoo. She met with the founders and proposed a merger. About 10 days later the founders, Yang and Filo, contacted her and said they wanted to talk to her but not about the merger. They wanted her to be their first employee and finally offered her 10% of the equity. She turned them down and the chance to earn \$3 billion!

I remember a VC once telling that a fund receives on average one reasonable proposal a month. But once a year a VC gets the deal where any fool could make money and which is a golden ring on the merry go-round of life. That is the deal you have to do and you have to forget the other 11.

For individuals the deal flow is less and I reckon about once every seven years you get a golden ring deal. Of course working out that it is a golden ring deal is not easy and there is much chaff compared with little wheat. But they do occur. A secret of a successful life is to be receptive to those opportunities when they do occur.

CONCLUSION

So these are my five lessons.

1. Have an SCA
2. Lease the Pencils
3. Know the Game
4. Know yourself in terms of stage of entrepreneur
5. Recognise and grab the golden ring

Try to both remember and implement them and the probability of becoming a successful entrepreneur will substantially improve.