What a Venture Capitalist Really Thinks—Musings, Observations and Reflections

Having sat in different chairs around the private investment table, first as a bank manager, then as a nonprofit marketing executive/administrator, institutional investor at a multi-billion-dollar public endowment fund, a start-up technology manager, incubator manager, investment banker, placement agent, and angel investor, I have come recently and lastly to the venture capital seat.

I tend to weight my investment decisions as follows: Management (who is in the deal), 50-60%; Market (size, niche, and CAGR), 20-25%; and everything else—Money, Metrics and Momentum, 20-25%. This latter category includes valuation, barriers to entry, competitive advantage, speed to market, size and stage of the round, risks, how much has been invested to date, how much management has invested, existence of intellectual property such as patents and trademarks and trade secrets, capital structure, exit strategy, scalability, sustainable margins, current and past revenues, revenue projections, sales pipeline, earnings forecast, and the presence (or absence) of a disruptive technology or business model.

There's a popular saying in private equity circles that "deals are like buses; there's a new one that comes along every 15 to 20 minutes." While somewhat facetious, there is a lot of truth in this simple tongue-in-cheek statement that speaks to the fast pace of the investment world, the volume of deal flow that professional investors receive, the naïve and myopic view of many entrepreneurs that their deal is somehow too good to pass up, and the lack of bandwidth and skeptical -- in some cases jaded -- nature of venture capitalists ("vc's").

To begin, the primary job of any venture capitalist is to say NO often, to say NO quickly, and to say NO gracefully but firmly enough so that "dead deals" do not keep trying to resurrect themselves (as opposed to having the Holy Spirit resurrect them). This is of necessity, and is part of the territory and job description of a vc, since on average less than 1% of the deals reviewed by venture capital firms each year receive investment capital and only 1-3% of all deals reviewed by vc's receive term sheets (investment offers) subject to final due diligence and agreement on valuation and other key financial and governance terms (thus the lower percentage of consummated or "closed" deals). So do not take a "NO" personally and do not become angry or defensive with a vc who asks tough questions or challenges your assumptions. Sometimes "No" has nothing to do with your company or presentation and everything to do with the investor—the stage of their fund cycle, their investment strategy and portfolio mix, problems with a portfolio company, having already invested in a competitor, macro or micro pressures or historical cycles or corrections in the capital markets, internal management issues, a defaulting limited partner, etc. Entrepreneurs need the gift of discernment and wisdom to understand the difference between "NO's" that mean "not now" and "NO's" that mean "not ever." Grace, composure and poise under pressure is always impressive, even to one's enemies and competition. Who knows, your thoughtful response to a turndown may be the "tipping point" that opens the door in the future or changes someone's mind. Instead, seek to learn what you can from the experience or process by asking how you could improve or change in the future. Also ask if the declining vc who is taking a "pass" can recommend other investors that might be a better fit for your company or project. You may or may not get a response, but your job is to keep learning until you get to the point of mastery—in both the business and personal realm. Finally, sending a simple "thank you" for a vc’s time within 24 hours of a meeting is just common courtesy and part of being a professional, not to mention glorifying and honoring to God.

Next, most (the majority) of the venture capital opportunities presented to vc’s offer real estate returns (2X to 3X ROI multiples) at venture capital risk. Such deals are unattractive to all but a handful of vc’s and are among the first to be turned down. My firm, for example, looks for deals where there is an opportunity to earn at least a 5x return on investment (500%), and preferably a 10x or greater return (1000%+). The Bible says in Genesis 26:12 that Isaac increased 100-fold in one year; 100-fold increase is 10,000%. The Bible also speaks of thousand-fold and above (100,000%) increase and levels of covenantal blessing (Deut. 1:11, Isa. 60:22, and Ps. 144:12-15). Opportunities with such order of magnitude increase that are exponential rather than incremental are described in the Bible as “storehouses.” Storehouses such as the granaries of Egypt (Gen. 41) have the ability to impact nations as opposed to just companies, cities or counties. There are modern-day storehouses such as Microsoft, Intel, Dell, Home Depot, Federal Express, Southwest Airlines, Amgen, eBay, Amazon, Berkshire Hathaway, Wal-Mart and others that have created and distributed tremendous wealth to the world via their charities, employees, investors, and taxes. I believe that God is now releasing to the body of Christ the keys to unlock storehouses for the kingdom and the knowledge of the “treasures hidden in darkness” (Isa. 45:3). The challenge for vc’s is to make the right investments to maximize the overall return for their particular fund. They are motivated and incentivized to do so because they share in the profits of their fund with their investors. Every venture fund needs at least one or more storehouse investments if it hopes to perform in the top quartile or decile and be able to raise its next fund.

One of the recurring questions by entrepreneurs to vc’s that is best left unasked is “Have you read my _______ yet?” or a variation, ‘What did you think of my _______?” Usually this refers to a business plan, executive summary, powerpoint presentation, technical white paper, product announcement, patent filing, engineering report, sales pipeline update, revenue forecast, conference exhibition or award, government policy change, new hire, or some other document the erstwhile entrepreneur has emailed to an investor. While there is nothing wrong with the question itself, it displays a lack of understanding and naivete about the hectic life and unending pressures of being a vc, not to mention manners and protocol, on the part of the entrepreneur. My advice is to ALWAYS assume vc’s have NOT read your information prior to a meeting unless they tell you otherwise. Then you will be adequately prepared to address any area of your company or plan that interests the investor, and you will save yourself some potential embarrassment and/or ill will. VC’s are not known for being timid or shy, and will typically indicate their preference for information by asking detailed and pointed questions. The best entrepreneurs and leaders are flexible and adaptable and able to adjust quickly to cues and feedback from their audiences and environments.

Another red flag for vc’s is when an entrepreneur or management team does not understand the difference between a venture deal and an angel deal. By definition, although there are exceptions and numbers are somewhat relative, an “angel” round of capital is considered to be $1.0 to 2.0 million or less in size by most investors. Stage is also a factor. “Angel” rounds are typically either the “Seed” round (first money) or the “Series A” round of capital, which is traditionally the first “outside” round of capital, meaning outside the founders, friends, family and fools. Typically investors receive common stock in seed rounds and preferred stock in later rounds, although this varies widely, and in the case of LLC corporate structures, units are offered instead of shares. In these early rounds, investors take higher risk for potentially higher reward. In contrast, a venture fund is much more likely to invest in the Series A or later rounds of capital in potential portfolio companies because of the risk-reward ratio (more on this later). In addition to size and stage, scalability is another measure of whether a particular deal is more suited to angels or vc's. A rule of thumb among vc's is that companies should be able to generate minimally $50MM or more (preferably much more) in revenue within five years of the vc's investment, and be operating in a market that is $1B or more in size (preferably much more). Companies that have pro forma or revenue projections showing $10, 15, 20, 30 or 40MM at the end of 5 years simply are too small and too risky for vc's and are a better fit for angel investors (these are referred to as "mom and pop" businesses). According to some estimates, $100-200B is invested annually by American angels (accredited individual investors) in early stage private equity deals versus around $20-25B by vc firms. In 2003, $18B was invested by vc's in 2,227 US companies. In 2000, the high water mark historically, more than $100B was invested by vc's in over 5,000 US based companies. In the first half of 2006, almost $13B ($12.88B) was invested by vc's in 1,713 US companies (Sources: NVCA, Center for Private Equity and Entrepreneurship, Dartmouth College; Center for Venture Research, University of New Hampshire).

My firm in general and I in particular prefer to invest in entrepreneurs and management teams who are relationship-oriented versus transaction-oriented. Don't get me wrong—transactions are necessary in order to generate revenues and profits—but there are people in the investment world (including brokers, investors, fund managers, day traders, and/or entrepreneurs) who are known by their reputation and behavior as "deal junkies." They have a short-term, "bottom-line" (theirs) focus on closing a deal or selling a company or selling their shares or closing a round of financing or selling a division or product line and being paid their fees or profits today. They have little or no interest in the longer-term, bigger picture of corporate performance, corporate ethics, product viability, market stability, share price earnings, investor returns, etc. When I worked at the public endowment fund, we looked for fund managers we could invest with over the next several fund cycles (the next 25-30 years), not just one cycle. We spent a lot of time and money on due diligence to gain understanding and insight into the people and their character and thought processes, systems and strategies before making an investment decision. A relationship orientation to me means essentially following the "Golden Rule" and treating others as you would like to be treated--being an effective communicator, being a person of integrity and candor, being forthright and honest in all of one's business and personal dealings, operating with a "covenant" mentality and spirit rather than a "cover-up" one, and making full disclosure on an ongoing regular basis to those who have a fiduciary or other legal right to be kept informed.

Another red flag is unrealistic time expectations by entrepreneurs regarding the investment process. Entrepreneurs who are desperate for an investment are less likely to be successful in raising and securing capital commitments. Part of the psychology of investing is the fact that investors are attracted to and invest in opportunity rather than need. The charitable impulse is triggered by need but the economic impulse is triggered by opportunity (some would say greed). The "Titanic Tenet" holds that investors, unlike some entrepreneurs, do not want to go down with a sinking ship, and in fact do not want to knowingly board such a ship in the first place. So entrepreneurs who ask for and expect to receive a check, bank wire, or commitment for investment from vc's within a few days or weeks of meeting are for the most part destined to disappointment (there are some notable exceptions to this within the vc community, and angel investors are not always as selective or sensitive about this as their vc counterparts); moreover, they set themselves up for continuing and repeated failure and become a self-fulfilling prophecy due to their lack of advance planning and understanding of the vc process. There are basically only two types or styles of fundraising—begging and investing. Entrepreneurs and executives who are wise will position themselves in the latter camp and avoid the former one.

Another phenomenon I would like to highlight is the difference between deals or companies that are "interesting" versus "compelling." Deals that are merely "interesting" require further analysis, research, thought, prayer, time, change, improvement, alignment, etc., whereas deals that are "compelling" have all or at least a critical mass (Momentum) of the ingredients necessary for success in place and investors are willing to write a check and sign a subscription agreement either today or on a definitive date in the near future, not some day yonder in the sweet by and by.

The method or mechanism of meeting is also important. There are two basic kinds of planned introductions or submissions by entrepreneurs to vc's—a personal referral by someone the vc knows and hopefully respects and trusts (there are different levels of credibility), or an "over the transom" cold call via an email, fax, phone call, overnight delivery, or postal ("snail") mail. There is also a third type of planned introduction, which is essentially a variation of the first two. In this case, an organization serves as proxy for a person in validating the introduction, and the level of credibility depends on both the reputation and stature of the organization, its requirements for membership, the registration fee, and whether the conference registration is open or closed in regard to membership. Thus financial and investment conference organizers woo and court investors as speakers for fees, *pro bono*, or reduced rates in order to attract those seeking capital to the conference at full price in the hopes of meeting someone they might never have a chance to meet otherwise. Finally, a fourth type of introduction happens spontaneously and naturally, without planning or forethought by either party, as entrepreneurs meet vc's on airplanes, trains, subways, and in hotels, restaurants, churches, synagogues, cathedrals, spas, resorts, sporting events, school reunions, and other places in the normal course of affairs and conduct of life. For obvious reasons, it is much better to have a personal referral from a trusted source or a "divine" referral from the Holy Spirit than to be labeled as an unsolicited over the transom cold call, which is almost always fatal due to the sheer volume of contacts vc's have each year and the need for external validation in order to help prioritize and screen deal flow.

Another red flag is entrepreneurs who think that just because God loves them that vc's should, too. Such "stinking thinking" and "sloppy agape" is usually fatal. This potential pitfall would also extend to any affinity group, for example Harvard alumni, or dog lovers, or people that own Siamese cats, or diabetics, or people born in Texas, or surfers who have lived in California, or military veterans, or corporate retirees, or Rhodes Scholars, or Nobel Prize Winners, or victims of sexual abuse or alcoholic families, or membership in the Mensa Society or Guinness Book of World Records. Just because an entrepreneur or executive happens to share one point of connection with a vc is no reason for them to check their brain at the door and assume they are "bosom buddies" and "home free." In fact, just the opposite. Apostle Paul said, "Study to show thyself approved, a workman that needeth not to be ashamed, rightly dividing the word of truth" (2 Tim. 2:15). Paul also said to be "thoroughly equipped for every good work" (2 Tim. 3:17) and to "be prepared in season and out of season" (2 Tim. 4:2) and "Let your speech be always with grace, seasoned with salt, that ye may know how ye ought to answer every man" (Col. 4:6). There are obvious natural applications for these spiritual principles in the business and financial world. Finally, never underestimate the power of agreement and prayer or the force of favor. God can do more for you in one second than you can do in a lifetime. Even natural, worldly wisdom acknowledges that "chance" favors the prepared mind, and that "luck" is where opportunity meets preparation. Obviously these concepts are anathema to Christians, or should be, but the point here is how much more God will honor the transformed mind that is surrendered to and regenerated by Him and open to supernatural wisdom, than the natural mind.

Finally, venture capital has its own language, and entrepreneurs must either learn the vocabulary or hire a translator/interpreter (attorney). Below are a few selected examples of venture capital terms with wrong definitions by design for humorous intent:

- Ratchet – not a Sears Craftsman toolchest
- Clawback – not a style or vintage of furniture
- Piggyback – not a "horse" ride for small kids
- ESOP – not a book of fables
- Pay to Play – not admission fees to a video arcade or amusement park
- Turnaround – not a highway or traffic sign
- Cramdown – not how you eat food or pack your luggage
- Preferred Return – not a tennis shot or mailing delivery option
- Profit – not a seer
- Mezzanine – not a half floor above the first floor
- Carried Interest – not the interest on your bank loan or mortgage debt
- Capital Call – not a call with your Congressman or Representative
- S1, S3 – not a social security or Swiss Bank Account number
- K1, 8K – not a type of military rations or canine corps
- 10Q – not an IQ score or game of 10 questions

In closing, I pray that this article has given you insight and/or revelation regarding the venture capital process, and encouraged and equipped you to understand the venture capital mindset and to go forth and do mighty exploits in the name of our God and to exercise dominion, might, rule and authority as you sit in the gates of our cities, nations, industries, professions, associations, and sectors to be His kings and queens in the earth. To Yahweh be the praise, glory and honor! Amen.