

Venture Capital

You have to ask yourself if venture capital is a realistic financing option for you. Most entrepreneurs who pursue venture capital don't qualify and merely end up wasting a lot of time (on average from 6 to 18 months) and energy in a futile pursuit.

There are problems associated with attracting venture capital as well.

To the uninitiated it sounds impressive and even glamorous to embark on such a path. However, to veteran entrepreneurs it's a strong indication of the rookie's naivety and lack of understanding of the consequences of accepting money from outsiders.

Venture capital brings with it tremendous meddling and pressure from venture capitalists who in this day and age typically lack both the operating and industry depth of their predecessors. The effect of this on fledgling ventures is loss of control by the entrepreneur which then frequently leads to bad--and sometimes fatal--business decisions being made.

Here are ten drawbacks of venture capital for the entrepreneur to mull over before making a decision to pursue it.

- * The decision to chase venture capital is often a tempting distraction from the much more complex and important entrepreneurial tasks of creating something to sell and persuading someone to buy it. The pursuit of venture capital is sometimes a means by which to postpone the day of reckoning when the marketplace finally decides if the idea will fly.
- * Venture capitalists behave like sheep investing only in whatever industry happens to be the flavor of the month. Everyone else need not apply.
- * Rookie entrepreneurs talking to venture capitalists expose their ideas to increased risk because they cannot distinguish between genuine interests to uncover corporate secrets.
- * Once negotiations begin venture capitalists will typically stall in order to push cash short companies to the brink of bankruptcy as a way of extracting additional equity and concessions at the last moment.
- * Terms demanded by greedy venture capitalists frequently work to erode and ultimately destroy the founding team's motivation and commitment to building a successful company.
- * With the first rupee of venture capital accepted the entrepreneur's control slips away to MBA wonder-boys with only the shallowest of operating experience.
- * As soon as venture capitalists become involved the founder's role shifts from critical company building functions to preparing reports, attending endless meetings, writing memos, and hand-holding impatient and/or meddlesome investors.
- * An infusion of capital often shifts the founding team's focus away from selling to spending money in an effort to placate venture capitalists who often confuse bulking-up staff and assets with real growth.
- * Venture capital brings with it tremendous pressure to create a liquidity event but this frequently results in bad decisions being made to launch products too early or enter into the wrong markets.

* The venture capitalist's knee-jerk response to every problem faced by a portfolio company is to fire the founders and evade any personal responsibility for bad decisions.

Here's a bonus 11th reason why venture capital is bad. It is by far the most expensive money an entrepreneur can ever tap into. Let's do the math to see why this is. Suppose you and a venture capitalist agree to a "pre-money" valuation of \$1 million for your start-up, and the venture capitalist then invests \$1 million for 50% of the equity. After the investment, the company is said to have a "post-money" valuation of \$2 million. Being 50/50 partners sounds acceptable, right?

Three years later the company is sold to a Fortune 500 corporation for \$5 million. Do you and the venture capitalist each get \$2.5 million from the proceeds? Not on your Nellie! The venture capitalist will have a so-called "liquidation preference" built into the original investment agreement which allows him to first take out 2 to 5 (or more) times his principal before anyone else sees a penny. So, let's say that in this example he takes out \$3 million (i.e., a "3X liquidation preference"), plus any accrued dividends on his preferred stock. After exercising the liquidation preference and cashing in his dividends only \$1 million is left. You, the founder, and your team, will then split this remaining money on a 50/50 basis with the venture capitalist.

This is a simplified example of what happens. In real life the founder and her team would probably receive far less than even the \$500,000 due to all the fine print clauses.

At this point, you really have to ask yourself if it's even worth the effort.

The good news is that there is a wealth of academic research to support the contention that anyone wishing to build a company for the long term will be better off by not utilizing venture capital. As a result savvy entrepreneurs devise startup strategies that allow them to focus on generating cash flow during the first year instead of chasing venture capital. Conversely, naive "entrepreneurial wanna-bees", such as those in the recent dotcom era, have a philosophy which can be summed up as, "Give me X million dollars or this idea is dead!".

If your entrepreneurial goal is a company "built to last" it's usually best to forgo venture capital. On the other hand, if your goal is a company "built to flip" for a fast buck use venture capital if it is available to you.