PricewaterhouseCoopers

3 Keys*

to Obtaining Venture Capital

10th Edition

*connectedthinking

A Message to Entrepreneurs

You have a vision.
PricewaterhouseCoopers helps bring that vision to reality. Our global presence, extensive knowledge of capital markets, and network of financing relationships provides access and introductions to many sources of funds—both domestic and international. We've helped hundreds of venture-backed companies secure financing, execute their plan, build value, and recognize that value through a successful IPO or trade sale.

Three Keys to Obtaining Venture Capital is designed to help first-time entrepreneurs understand the venture capital process and provides a useful step-by-step tool for creating a business plan. Through this understanding, and armed with a comprehensive and thorough business plan, an entrepreneur will have realistic expectations and can concentrate on targeting the financing search for the most promising investment sources.

For the PricewaterhouseCoopers technology or venture capital leader nearest you, call the Technology Industry Hotline at 1-877-PwC-TICE or visit our Vision to Reality Web site at www.pwc.com/v2r and click on "Find a Professional."

Tracy T. Lefteroff
Global Managing Partner, Private Equity
PricewaterhouseCoopers LLP

About PricewaterhouseCoopers
PricewaterhouseCoopers (www.pwc.com) provides industry-focused assurance, tax, and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 130,000 people in 148 countries work collaboratively using Connected Thinking to develop fresh perspectives and practical advice.

"PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Introduction to the 3 Keys

Understand the Process

To an entrepreneur seeking venture capital financing for the first time, an understanding **(pages 5-6)** of the venture capital process is essential. The venture capital industry includes many firms with substantial funds to invest; however, it is often a challenge for an entrepreneur to tap into this vital source of financing. This publication is designed to ease the challenge by providing insights into obtaining venture capital financing.

The venture capital process begins with an introduction to a venture capitalist. Cold calling on venture capitalists is a long-shot—venture capitalists see many “over the transom” deals, very few of which become investments. Introductions to venture capitalists through referral sources they respect improve the odds of securing financing. As the leading auditor of VCs in the U.S., PwC is in the unique position to assist with this task.

Target a Venture Capital Partner

Choosing the right venture capital firms is an important part of the fundraising process. An entrepreneur who has not researched and targeted venture firms runs the risk of lengthening the search and overshopping the plan. Venture capitalists readily exchange information, so rejection from one firm may influence others.

The criteria for selecting the right venture capitalists to approach include their geographic and industry specialization, stage of company development, and size of investment preferences. Also important are whether the fund will act as a lead investor and whether there are complementary or competing companies within the fund’s portfolio.

The research of a fund’s preferences can be done by obtaining literature from the funds directly, talking to venture-backed entrepreneurs, visiting the PricewaterhouseCoopers MoneyTree™ Web site at www.pwc.com/moneytree, and by obtaining our quarterly *nextwave* publication—a digest of ideas and investment trends for entrepreneurs. See the back of this book for ordering information. You can also contact PricewaterhouseCoopers directly at 1-877-PwC-TICE. Our professionals are active in the venture community and welcome the opportunity to talk with you.

Write the Business Plan

Often the first step in dealing with venture capitalists is to forward them a copy of the business plan **(pages 7-11)**. And, because venture capitalists have to deal with so many business plans, the plan must immediately grab the reader’s attention. The executive summary will either entice venture capitalists to read the entire proposal or convince them not to invest further time.

A good plan is crucial for two reasons: first, as a management tool; and second, as a means to obtain financing. While the plan is an essential element in securing financing, it should also be an operating guide to the business—with the goals, objectives, milestones, and strategies clearly defined and well-written. This is the best way to demonstrate the viability and growth potential of the business and to showcase the entrepreneur’s knowledge and understanding of what is needed to meet the company’s objectives. The first reading of a plan is the venture capitalist’s initial opportunity to evaluate the individuals who will manage the business and to measure the potential for return on this investment.

The plan should also address the following business issues from the perspective of the venture capitalist:

- Is the management team capable of growing the business rapidly and successfully?
- Have they done it before?
- Is the technology fully developed?
- Is the product unique, and what value does it create so that buyers will want to purchase the product or service?

- Is the market potential large enough?
- Does the team understand how to penetrate the market?
- Do significant barriers to entry exist?
- How much money is required and how will it be utilized?
- What exit strategies are possible?

If the plan is of interest, the entrepreneur will be contacted for the first of what will generally be several meetings, and the venture capitalist may begin the due diligence process. Since venture firms are in the business of making risk investments, one can be certain a thorough analysis of the company's business prospects, management team, industry, and financial forecasts will precede any investment.

Prepare for the Negotiation Process

Following due diligence, the successful venture will then enter into the negotiation process, where the structure and terms of financing will be determined. The entrepreneur must carefully prepare for this next step by becoming familiar with the various structures of venture capital financing and preparing a bargaining position after consulting with an attorney who has extensive venture capital experience. Attorneys will give guidance on the issues worth fighting for. Issues to consider are: vesting, salary, stock restrictions, commitment to the venture, debt conversion, dilution protection, downstream liquidity, and directors. Additionally, an entrepreneur should be prepared for the possibility that a venture capitalist may want to make extensive changes to the management team. The negotiation will involve most or all of these issues in addition to price-per-share. However, price-per-share concerns should not be the overriding interest; the end result of this process must be a win/win situation in order for the relationship to progress successfully. The last step is to document and close the transaction —resulting in a term sheet, investment agreement(s) and, finally, the closing.

Pricing and Control: The Investors' Perspective

Pricing venture capital deals involves the estimated future values of the entity being financed and is highly subjective. Theoretical approaches can be used to estimate the company's future value and the corresponding percentage ownership that the investor requires—in other words, estimated future value based on the venture's expected profitability and estimated earnings multiples. The estimated percentage of ownership the investor must receive can then be calculated to derive the desired return on investment.

Venture capitalists expect an annual rate of return of 30 to 40 percent or more. The table below shows the percentage investment a venture capitalist would need to realize to support a 30 percent return on investment at various estimated market values. As shown, to realize a 30 percent return on an investment of $8 million, a venture capitalist would need to own 22 percent of a company with an estimated future market value of $175 million after six years. If the estimated future market value is higher—$200 million for example—a smaller percentage of ownership (19 percent) would provide the required rate of return.

Ownership Required to Support a 30% Return

Most VCs require a 30% ROI. The chart below estimates what percentage of ownership an entrepreneur will have to give up in order for a VC to receive a 30% ROI.

Estimated Future Market Value of a Company in Six Years

		$75	$125	$150	$175	$200
VC Investment	$6	39%	23%	19%	17%	14%
	$7	45%	27%	23%	19%	17%
	$8	51%	31%	26%	22%	19%
	$9	58%	35%	29%	25%	22%
	$10	64%	39%	32%	28%	24%

$ in millions

Prepare the Financials

Realistic financial forecasts **(pages 12-16)** within the business plan are important to attract investors and retain their interest to participate in future rounds of financing. The financials must accurately reflect the various product development, marketing, and manufacturing strategies described in each section of the plan.

Helping Companies Manage Fast Growth

Fast-growth companies with extraordinary potential move from vision to reality in a very short period of time. PricewaterhouseCoopers can help navigate through these hazardous areas.

RISKS AND CONTROLS Accelerated lifecycles create a number of stresses and traumas within a company's infrastructure. PwC helps companies address these growing pains and pave the way for clear growth. We offer modular and scalable diagnostic tools that identify risk hazards and opportunities around financial controls and procedures, e-business, information technology, and other key areas. We deliver recommendations based upon control benchmarks and best practices.

TAX STRATEGIES Companies with extraordinary potential also pursue strategic tax planning early on as they ready for fast growth. PwC helps develop tax strategies to optimize the areas of R&D, intellectual property ownership, manufacturing, sales and marketing, and global expansion early in a company's growth cycle.

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The 1st Key: Understanding the Process

Profile of a Typical Venture Capital Fund

Professionally managed venture capital funds provide seed, start-up, and expansion financing as well as management/leveraged buyout financing. In addition to these distinctions, funds may also specialize in technology sectors such as life sciences—while others invest in a wide array of technology and non-technology related arenas.

Venture capital firms are typically established as partnerships that invest the money of their limited partners. The limited partners are usually corporate pension funds, governments, individuals, foreign investors, corporations, insurance companies, endowment funds, and even other venture capital funds. When venture capital firms raise money from these sources, they group the committed money into a fund. A typical fund might close at $300-$500 million and actively invest for three to five years. Since investors in venture capital funds have specific return-on-investment requirements, a venture capitalist must evaluate potential investments with a similar return-on-investment consideration.

Since the return-on-investment is critical, venture capitalists invest with certain criteria in mind. Many funds invest between $6-$10 million in any one company over a three- to five-year period and look for companies with market potential of $75-$200 million. Since a venture fund typically invests in only 20-30 companies, each investment must be screened carefully. Venture capitalists will be looking for a 30 to 40 percent—or more—annual return-on-investment and for a total return of five to 20 times their investment.

Venture capitalists are not passive investors and become involved as advisors to management, usually as members of the company's board of directors. Venture capitalists seek to maximize their return by actively participating in their investments.

Just as venture capitalists perform due diligence, an entrepreneur must evaluate the benefits that a particular venture firm can provide to the company.

- Do the venture capitalists have experience with similar types of investments?
- Do they take a highly active or a passive management role?

- Are there competing companies in their portfolio?
- Are the personalities on both sides of the table compatible?
- Does the firm have strong syndication ties with other venture firms for additional rounds of financing?
- Can they help provide contacts for distribution channels and executive search?

The Valuation Process

It is critical for an entrepreneur seeking venture capital to assess the value of the company from the perspective of the venture capitalist and to appreciate the dynamics of the entrepreneur/venture capitalist relationship. This relationship revolves around a trade-off. Funds for growth are exchanged for a share of ownership. The entrepreneur will be asked to give up a large share of ownership of the company, possibly a majority stake. The venture capitalist seeks to value the company to provide a return on investment commensurate with the risk taken.

Entrepreneurs seek to raise as much money as they can while giving up as little ownership as possible. Venture capitalists strive to maximize their return-on-investment by putting in as little money as possible for the largest share of ownership. Through the negotiation process, the two parties come to agreement. Entrepreneurs understand that excess funding costs them equity. Venture capitalists must leave company founders with enough ownership to provide incentive to make the business succeed. To balance their individual goals, both parties should agree on one mutual goal—to grow a successful enterprise.

The first step in the negotiation process is to determine the current value of the company. The most important factor in determining this "pre-money valuation"—or the value of the company prior to funding—is the stage of development. A business with no product revenues, little expense history, and an incomplete management team will usually receive a lower valuation than a company with revenue that is operating at a loss. This is because a company generating revenue has completed the R&D process for their product, thereby eliminating the greatest risk—product failure in R&D. Each successive stage commands higher valuations as the business achieves milestones, confirms the ability of the management team, and progresses in reducing fundamental risks.

Stage I – Seed

Companies have no product revenues to date and little or no expense history, usually indicating an incomplete team with an idea, plan, and possibly some initial product development.

Stage II – Early

Companies still have no product revenues, but some expense history suggesting product development is underway.

Stage III – Expansion

Companies show product revenues, but they are still operating at a loss.

Stage IV – Later

Companies have product revenues and are operating profitably.

The best way to build value in a company is to achieve the goals and milestones within the timeframes designated in the plan.

As milestones are achieved, risk is reduced and subsequent rounds of financing can usually be raised at more attractive valuations.

DO...

...have a clear and logical explanation about the investor's exit strategy.

The 2nd Key: Writing the Business Plan

Why Is a Business Plan Needed?

A quality business plan is an important first step in convincing investors that the management team has the experience to build a successful enterprise. The plan also provides measurable operating and financial objectives for management and potential investors to measure the company's progress.

Executive Summary

Business plans should be summarized into a short two- to three-page synopsis called the executive summary. The summary is used to capture the essence of the plan and generate interest so the reader further studies the full proposal. It is the most important section of the business plan and should be written last, ensuring that only vital information is included.

At many of the largest venture capital firms, fewer than five percent of the hundreds of plans received are reviewed beyond the executive summary. While sometimes this is because the business does not fit the type of investment favored by that firm, more often it is because the executive summary is not written convincingly or clearly enough. The summary must stand out and be noticed, and to do this it must be of the highest quality. The summary must be persuasive in conveying the company's growth and profit potential and management's prior relevant experience.

The effort taken in researching investor preferences and preparing a quality summary will set the plan apart and assure that it receives further consideration by venture capital firms.

Outline for Executive Summary

Company Overview

Generally, the investor wants to know—in a hurry—what product the company is developing, the market/industry it serves, a brief history, milestones completed (with dates), and a statement on the company's future plans. If the company is an ongoing business seeking expansion capital, the entrepreneur must summarize the company's financial and market performance to date.

Management Team

List the key members of the management team and technical advisors—including their age, qualifications, and work history. It is important to emphasize the team's relevant, proven track record. Note key open positions and how the company intends to fill them.

Products and Services

Provide a short description of the product or service and highlight why it is unique (i.e., what makes it better than its potential competitors). Discuss any barriers to entry that prevent further competition (e.g., patents). Mention the product's direct or indirect competition. If possible, briefly mention future product development plans such as upgrades or product line extensions in order to show the investor that the company is not a one-product/service enterprise.

DO...

...be brief. Begin with a two- to three-page executive summary. Then, limit the body of the plan to seven-to-ten typewritten pages. Note that internal business plans and budgets are normally more detailed than those presented to external investors. Include everything important to the business andfinancing decision, but leave secondary issues and information, such as detailed financial information, for discussion at a later meeting.

Market Analysis

Define the target market to be served using recent market data and analysts' estimates of current and projected size and growth rates. Also note what percentage of the market the company plans to capture. Mention the names of your largest current, well-known customers who have either purchased your product or given you letters of intent. It is important to discuss who will buy the product and why. Briefly note the distribution/selling strategies used in the industry and explain which one(s) you plan to use to penetrate the market.

Funds Requested and Uses

State the amount of money required and be specific in the description of the uses of the funds sought. Avoid general terms such as "working capital."

Summary of Five-Year Financial Projections

This section should summarize key financial projections through breakeven. Only projected revenues, net income, assets, and liabilities should be listed. It is also useful to note additional expected rounds of financing needed.

DO...

...enclose the proposal/business plan in an attractive but not overdone cover.

DO...

...provide extra copies of the plan to speed the review process.

Visit the PricewaterhouseCoopers Entrepreneur Resource Center for more insights

Join us at www.pwc.com/v2r and discover the wealth of tools and insights we offer to help bring your vision to reality. Download sample plans and templates. Review financial models. Explore your financial alternatives. Find out how valuations are determined. Link to the MoneyTree Survey Web site and other useful sites.

Body of the Plan

DO...

...let the reader know, early on, what type of business the company is in. While this may seem obvious, many plans tell the reader this information too far into the plan and with other plans the reader is never certain.

...state the company's objectives.

...describe the strategy and tactics that will enable the company to reach those objectives.

Company Overview

In this section one should fully describe the reason for founding the company and the general nature of the business. The investor must be convinced of the uniqueness of the business and gain a clear idea of the market in which the company will compete. The entrepreneur's vision for the company's future production and operations strategy should also be described. An investor needs to be assured that the company is built around more than a product idea. The entrepreneur needs to demonstrate that a profitable business can be built based on the strategies detailed in the plan

Products and Services

The business plan must convey to the reader that the company and product truly fill an unmet need in the marketplace. The characteristics that set the product/service and company apart from the competition need to be defined. It is also important to describe each of the end-user segments that will be targeted. A full profile of the end-users and the key potential applications of the product will demonstrate to an investor that the entrepreneur has done his/her marketing homework. A description of the status of patents, copyrights, and trade secrets is very important. It is equally imperative to describe barriers to entry. Keep in mind that patents are only as good as they are defensible.

DON'T...

...use highly technical descriptions of products, processes, and operations. Use common terms. Keep it simple and complete.

The plan should list all the major product accomplishments achieved to date as well as remaining milestones. Knowing that the entrepreneur has tackled several hurdles and is aware of upcoming challenges and how to surmount them will provide investors with a greater comfort level. Specific mention should be made of the results of alpha (internal) and beta (external with potential customers) product testing. If alpha or beta tests are upcoming, mention how these tests will be conducted.

Single product companies can be a concern for investors. It is always beneficial to include ideas and plans for future products/services. If the plan demonstrates the viability of several products, an investor will see an opportunity to grow a successful business.

Market Analysis

The analysis of market potential separates the inventors from entrepreneurs. Many good products are never successfully commercialized because their inventors don't stop to understand the market or assemble the management team necessary to capitalize on the opportunity.

This section of the business plan will be scrutinized carefully. Market analysis should, therefore, be as specific as possible, focusing on believable, verifiable data. Market Research should contain a thorough analysis of the company's industry and potential customers. Industry Data should include growth rates, size of the market, recent technical advances, government regulations, and future trends. Customer Research should include the number of potential customers, the purchase rate per customer, and a profile of the decision-maker. This

DO…

...be realistic in making estimates and assessing the market and other potentials.

...discuss the company's business risks. Credibility can be seriously damaged if existing risks and problems are discovered by outside parties.

research drives the sales forecast and pricing strategy, which relates to all other strategies in marketing, sales, and distribution. Finally, comment on the percentage of the target market the company plans to capture.

Management and Ownership

Venture capitalists invest in people—people who have run or who are likely to run successful operations. Potential investors will look closely at the members of the company's management team. The team should have experience and talents in the key disciplines: technological development, marketing, sales, manufacturing, and finance. This section of the plan should therefore introduce the members of your management team and what they bring to the business. Detailed resumes should be included in an appendix.

The management team in most start-up companies includes only a few founders with varied backgrounds and an idea. If there are gaps in the team it is important to mention them and comment on how the positions will be filled. Glossing over a key unfilled position will raise red flags. Often, because venture capital investors have access to networks of management talent, they can provide a list of proven candidates appropriate for these crucial positions.

Include a list of the board of directors or advisors: key outside industry or technology experts who lend guidance and credibility. This is another area where empty positions may be filled from suggestions of a well-networked investor.

Marketing Plan

The primary purpose of the marketing section of a business plan is to convince the venture capitalist that the market can be developed and penetrated. The sales projections made in the marketing section will drive the rest of the business plan by estimating the rate of growth of operations and the financing required.

The plan should include an outline of the strategy for:

- Pricing;
- Distribution channels; and
- Promotion.

Pricing

The strategy used to price a product or service provides an investor with insight for evaluating the strategic plan. Explain the key components of the pricing decision—i.e., image, competitive issues, gross margins, and the discount structure for each distribution channel. Pricing strategy should also involve consideration of future product releases and future products.

Distribution Channels

A manufacturer's business plan should clearly identify the distribution channels that will get the product to the end-user. For a service provider, the distribution channels are not as important as are the means of promotion. Distribution options for a manufacturer may include:

- Direct Sales—such as mail order, direct contact through salespeople, and telemarketing;
- Original Equipment Manufacturers (OEM)—integration of the product into other manufacturers' products;
- Distributors or Wholesalers; or
- Retailers.

Each of these methods has its own advantages, disadvantages, and financial impact, and these should be clarified in the business plan. For example, assume the company decided to use direct sales because of the expertise required in selling the product. A direct sales force increases control, but it requires a significant investment. A venture capitalist will look to the entrepreneur's expertise as a salesperson, or to the plans to hire, train, and compensate an expert salesforce. If more than one distribution channel is used, they should

all be compatible. For example, using both direct sales and wholesalers can create channel conflict if not managed well.

Fully explain the reasons for selecting these distribution approaches and the financial benefits they will provide. The explanation should include a schedule of projected prices, with appropriate discounts and commissions, as part of the projected sales estimates. These estimates of profit margin and pricing policy will provide support for the decision.

Promotion

The marketing promotion section of the business plan should include plans for product sheets, potential advertising plans, Internet strategy, trade show schedules, and any other promotional materials. The venture capitalist must be convinced that the company has the expertise to move the product to market. A well thought-out promotional approach will set the business plan apart from the competition.

It is important to explain the thought process behind the selected sources of promotion and the reasons for those not selected.

Competition

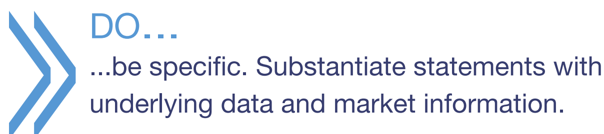
A discussion of the competition is an essential part of the business plan. Every product or service has competition. Even if the company is first-to-market, the entrepreneur must explain how the market's need is currently being met and how the new product will compete against the existing solution. The venture capitalist will be looking to see how and why the firm will beat the competition. The business plan should analyze the competition, giving strengths and weaknesses relative to the product. Attempt to anticipate competitive response to the product. Include, if possible, a direct product comparison based on price, quality, warranties, product updates, features, distribution strategies, and other means of comparison. Document the sources used in the analysis.

Operations

The operations section of the business plan should discuss the location and size of the facility. If one location is selected over another, be sure to include justification. Factors such as the availability of labor, accessibility of materials, proximity to distribution channels, and tax considerations should be mentioned. Describe the equipment and the facilities. If more equipment is required in response to production demands, include plans for financing. If the company needs international distribution, mention whether the operations facility will provide adequate support. If work will be outsourced to subcontractors—eliminating the need to expand facilities—state that, too. The investor will be looking to see if there are inconsistencies in the business plan.

If a prototype has not been developed or there is other uncertainty concerning production, include a budget and timetable for product development. The venture capitalist will be looking to see how flexible and efficient the facility plans are. The venture capitalist will also ask questions such as:

- If sales projections predict a growth rate of 25 percent per year, does the current site allow for expansion?
- Are there suppliers who can provide the materials required?
- Is there an educated labor force in the area?



These and any other factors that might be important to the investor should be included. The sales projections will determine the size of the operation and thereby the funds required both now and in the future. Include the sources and uses of financing in the business plan, and be certain the assumptions are realistic. The timing and the amount of funds will be derived from the sales estimates.

DON'T…

...make vague or unsubstantiated statements. For example, don't just say that sales will double in the next two years or that new product lines will be added without supporting details.

The 3rd Key: Preparing the Financials

The Purpose of Financial Forecasts

Developing a detailed set of financial forecasts demonstrates to the investor that the entrepreneur has thought out the financial implications of the company's growth plans. Good financial forecasts integrate the performance goals outlined in the plan into financial goals so that return-on-investment, profitability, and cash-flow milestones can be clearly stated. Investors use these forecasts to determine if (a) the company offers enough growth potential to deliver the type of return-on-investment that the investor is seeking, and (b) the projections are realistic enough to give the company a reasonable chance of attaining them.

Content of Financial Forecasts

Investors expect to see a full set of cohesive financial statements—including a balance sheet, income statement, and cash-flows statement—for a period of three to five years. It is customary to show monthly statements until the breakeven point or profitability is reached. Thereafter, quarterly statements should be prepared for two years, followed by yearly data for the remaining timeframe. It is also imperative that the forecasts include a footnote section that explains the major assumptions used to develop revenue and expense items. It is not advisable to "ramp up" sales and expenses in sequential fashion—this gives the impression that the financial implications of the plan have not been fully thought out. Prepare the financial projections as the final step in putting together the business plan. The following section contains some helpful hints on how to develop sound assumptions from which to base projections.

DO…

...summarize and properly structure internal budgets and plans to facilitate review by outside parties.

Assumptions to Use in Forecasts

Sales

Preparing the sales forecasts can be a difficult process, especially in a developing or niche market. Typically, the plan should state an average selling price per unit along with the projected number of units to be sold each reporting period. Sales prices should be competitive with similar offerings in the market and should take into consideration the cost to produce and distribute the product.

DO…

...cite clearly how much money the company will need, over what period of time, and how the funds will be used.

Cost of Sales

Investors will expect accurate unit cost data, taking into consideration the labor, material, and overhead costs to produce each unit. Be sure to have a good grasp on initial product costing so it is protected against price pressure from competitors. This data will also be important for strategic "make versus buy" decisions.

Product Development

Product development expenses should be closely tied to product introduction timetables elsewhere in the plan. These expenses are typically higher in the early years and taper off because product line extensions are less costly to develop. Investors will focus on these assumptions because further rounds of financing may be needed if major products are not introduced on time.

Other Expenses

A detailed set of expense assumptions should take into consideration headcount, selling and administrative costs, space, and major promotions. It is useful to compare final expense projections with industry norms. All expense categories should be considered.

Balance Sheet

The balance sheet should agree with the income and cash flows statement. Consideration should be given to the level of inventory and capital expenditures required to support the projected sales level. It is important to limit capital expenditures at the outset to current requirements because cash will be harder to come by if fiscal restraint is not demonstrated to investors. It is generally better to rent or lease capital equipment in the first few years in order to conserve cash for marketing and selling expenses that will generate sales.

Cash Flows

The cash-flows statement must correlate to the balance sheet and income statement and should mirror the timing of the funding requirements stated in the plan. Investors will study the cash-flows statement to determine when cash-flow breakeven is expected and when periodic needs are anticipated. Venture capital firms set aside a certain percentage of their funds for follow-on financing to address these periods of need by their portfolio companies, but the cost in lower valuations for unanticipated financings can be high. This is why it is important to set realistic forecasts so that the initial request covers the capital needs until the business can complete milestones leading to higher valuations in future rounds.

Examples of Financial Forecasts

The financial forecasts illustrated below represent a fast-growth, technology-oriented manufacturing company. The forecasts are shown on a yearly basis. An actual business plan, however, should show monthly figures until breakeven and then quarterly statements for subsequent years. The assumptions are included as a guide and may not apply to all start-up companies. Be sure to consult your financial advisor.

Fast Track, Inc.

Income Statement (000s omitted)

	Year 1	Year 2	Year 3	Year 4	Year 5
Product Sales	$1,197	$3,699	$7,500	$16,685	$37,349
Service Revenue	81	572	1,509	2,499	3,934
Total Revenue	**1,278**	**4,271**	**9,009**	**19,184**	**41,283**
Cost of Sales					
Direct Materials	474	995	2,434	4,532	11,674
Overhead	164	705	900	1,860	2,708
Service Cost	41	286	755	1,250	1,967
Total Cost of Sales	**679**	**1,986**	**4,089**	**7,642**	**16,349**
Gross Margin	**599**	**2,285**	**4,920**	**11,542**	**24,934**
Operating Expense					
R&D	270	462	618	1,158	1,958
Marketing/Sales	351	829	1,605	3,109	5,968
Administration	1,465	1,660	2,154	2,805	4,179
Total Operating Expense	**2,086**	**2,951**	**4,377**	**7,072**	**12,105**
Income (loss) Before Int. and Tax	(1,487)	(666)	543	4,470	12,829
Interest Expense	0	0	0	0	0
Interest Income	33	21	44	118	340
Income (loss) Before Taxes	**(1,454)**	**(645)**	**587**	**4,588**	**13,169**
Tax Expense	**0**	**0**	**0**	**1,231**	**5,268**
Net Income (loss)	**$(1,454)**	**$(645)**	**$587**	**$3,357**	**$7,901**

Fast Track, Inc.

Balance Sheet (000s omitted)

	Year 1	Year 2	Year 3	Year 4	Year 5
Assets					
Current Assets					
Cash	$341	$583	$398	$30	$1,585
Accounts Receivable, Net	256	1,452	2,152	5,522	10,991
Inventory	211	909	1,312	2,775	6,753
Total Current Assets	808	2,944	3,862	8,327	19,329
Property, Plant, and Equipment (PPE)	64	137	248	430	690
Less Accumulated Depreciation	14	50	115	215	366
Net Property, Plant, and Equipment	50	87	133	215	324
Total Other Long-Term Assets	3	1	0	0	0
Total Assets	**$861**	**$3,032**	**$3,995**	**$8,542**	**$19,653**
Liabilities					
Short-Term Liabilities					
Accounts Payable	$114	$282	$473	$999	$2,609
Accrued Expenses	191	329	503	848	1,398
Salaries Payable	10	20	31	42	83
Taxes Payable	0	0	0	308	1,317
Total Short-Term Liabilities	315	631	1,007	2,197	5,407
Long-Term Liabilities	0	0	0	0	0
Total Liabilities	**$315**	**$631**	**$1,007**	**$2,197**	**$5,407**
Equity					
Common Stock	$500	$500	$500	$500	$500
Preferred Stock	1,500	4,000	4,000	4,000	4,000
Retained Earnings	(1,454)	(2,099)	(1,512)	1,845	9,746
Total Equity	**546**	**2,401**	**2,988**	**6,345**	**14,246**
Liabilities and Equity	**$861**	**$3,032**	**$3,995**	**$8,542**	**$19,653**

Fast Track, Inc.

Statement of Cash Flows (000s omitted)

	Year 1	Year 2	Year 3	Year 4	Year 5
Operating Activities					
Net Income (loss)	$(1,454)	$(645)	$587	$3,357	$7,901
Add: items not requiring cash in the current period					
Depreciation/Amortization	14	36	65	100	151
Changes in Operating Assets and Liabilities					
Accounts Receivable	(256)	(1,196)	(700)	(3,370)	(5,469)
Inventory	(211)	(698)	(403)	(1,463)	(3,978)
Other Long-Term Assets	(3)	2	1	0	0
Accounts Payable	114	168	191	526	1,610
Accrued Expenses	191	138	174	345	550
Salaries Payable	10	10	11	11	41
Taxes Payable	0	0	0	308	1,009
Net Cash Provided by (used in) Operating Activities	**(1,595)**	**(2,185)**	**(74)**	**(186)**	**1,815**
Investing Activities					
Capital Expenditure (PPE)	(64)	(73)	(111)	(182)	(260)
Net Cash Used in Investing Activities	**(64)**	**(73)**	**(111)**	**(182)**	**(260)**
Financing Activities					
Equity Investment	2,000	2,500	0	0	0
Net Cash Provided by Financing Activities	**2,000**	**2,500**	**0**	**0**	**0**
Change in Cash	341	242	(185)	(368)	1,555
Cash, Beginning of Year	0	341	583	398	30
Cash, End of Year	**$341**	**$583**	**$398**	**$30**	**$1,585**

Fast Track, Inc.

Summary of Forecast Assumptions

This footnote section will summarize the assumptions developed in Section 3. It should highlight key points of the plan that relate to cash flows and requirements for funds, as well as assumptions used to develop the forecasts.

Year	Units	Unit Price	Product Revenues*	Service Revenues*	Total Revenues*
1	42	$28,500	$1,197	$81	$1,278
2	137	27,000	3,699	572	4,271
3	300	25,000	7,500	1,509	9,009
4	710	23,500	16,685	2,499	19,184
5	1,690	22,100	37,349	3,934	41,283

* 000s omitted: small rounding adjustments included

The product sales forecast reflects the following unit and pricing assumptions:

Sales:

- Product revenue is recognized at time of shipment.
- Declining unit prices reflect savings from economies of scale as well as a more competitive environment beginning in year two.
- Total revenue reflects the company's target of owning 10 percent of the market by year five.
- Service revenue increases are due to growing product-installed base.

Expenses:

- Salaries are based on competitive compensation.
- Operating expenses include estimates for supplies, travel, and telephone.

Balance Sheet:

- Accounts receivable are collected 72 days from sales (turnover rate of five times a year).
- The reserve for warranty is two percent of product sales.
- Organizational costs are amortized over three years.
- Inventory is assumed to turn on average three times a year.
- Fixed assets include both purchased equipment and leasehold improvements.
- Depreciation is based on three- to five-year lives.
- Accounts payable reflect a 60-day payment cycle.
- Accrued expense includes overhead cost, service cost, and operating costs for one month.
- Salaries are paid bi-monthly.
- Taxes are paid in the month following each fiscal quarter and are assumed to be at a combined rate of 40 percent.
- Income tax expense assumes that losses will carry forward until income is earned. Years three and four tax expenses are reduced by the net loss carryforwards of prior years.
- Preferred and common stock are issued as shown.

Cash-Flows Statement:

- The cash-flows statement is based on the spending and payment decisions of the income and balance sheets.
- Equity investment includes founders' and initial investors' common stock of $500,000, plus the venture capitalists' investment of $1,500,000.

Tips for the Plan Preparer—Financial Calculations

$$\text{Accounts Receivable, Net Days Sales Outstanding} = \frac{\text{Sales}}{\text{Average Accounts Receivable*}}$$

$$\text{Inventory Turns} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

$$\text{*Average Accounts Receivable} = \frac{\text{Beginning Accounts Receivable} + \text{Ending Accounts Receivable}}{2}$$

Beyond the 3 Keys

Tips to Separate Your Plan from the Rest

- Spend time writing a succinct and persuasive executive summary, but write the body of the business plan first.
- Create a professional, graphically pleasing document. Make sure that it is well indexed for easy reference. Number copies sequentially so that investors will know that only a select few copies are being distributed. Include a cover letter addressed to a specific contact person in the firm and follow up with a phone call. Include a phone number and e-mail address so the investor can reach you with questions.
- Use references or introductions from sources respected by venture capitalists. Have your plan referred through an accountant or attorney with a strong venture capital practice.
- Spend time researching potential venture capital investors so that you send the plan only to those who specialize in making investments to companies in your industry. This research may also help you discover something about the investor that you can use to get your plan noticed.
- Plan the fundraising strategy through several rounds. The initial financing will typically lead to subsequent rounds, and presenting a realistic timeline demonstrates to an investor that the plan is carefully prepared.

Alternative Financing Sources

Friends and Relatives

Many companies have financed their development stages through the help of friends and relatives. Points to consider include: (1) how much equity to give to these early investors; (2) how to keep family relationships intact if the venture fails; and (3) involvement of family members in the daily operation of the business. Be sure to consult an attorney specializing in venture-backed deals for guidance on proper structuring to avoid possible hang-ups later.

Angels

Angels are usually wealthy individuals who are former entrepreneurs or executives who invest in entrepreneurial companies. There are many investment clubs across the country that serve as a network for such individuals.

Debt Instruments

If the business opportunity you are pursuing is the purchase/expansion of an existing business, you may want to consider various debt instruments. Advantages include retaining equity, fixed interest payments, and flexible payment payback terms. Convertible debt is useful for companies that have a high degree of risk but do not want to give up a large portion of equity. The conversion feature of convertible debt is attractive to investors or banks who typically make loans but require equity for their added risk.

Joint Ventures

These have become increasingly popular for medical/biotechnology companies in the past few years, but any company can benefit from having a strong corporate partner. Joint venture agreements must be carefully structured to avoid relinquishing major shares of royalties or marketing rights to the partner. Expectations for both sides should be carefully documented.

Corporate Venture Capital

Many public companies have either a venture fund or business development group for strategic alliances and acquisitions, or both. Generally the venture arm of a public company will only invest “behind” a venture capitalist, leaving the due diligence and active management involvement to the venture capital investor. As noted earlier, a network of advisors is an important referral source to venture professionals and are another means to identify the “right” venture firms to approach—leading to possible direct referrals. While there are no comprehensive guides to locate corporate investors, most participate actively in venture conferences and local industry organizations and associations.

How PricewaterhouseCoopers Can Help

Business Advisors

Whether your company is an emerging business seeking venture capital, or an established company seeking to expand through a merger, acquisition, joint venture, or strategic alliance, you can rely on PricewaterhouseCoopers for a full range of support services. Our global presence, extensive knowledge of capital markets, and network of financing relationships provides access and introductions to many sources of funds—both domestic and international.

Since PricewaterhouseCoopers is the first choice for accounting services among the nation’s top 100 technology-based venture capital firms, we are knowledgeable about the issues that arise between entrepreneurs and venture capitalists. We excel at:

- Assisting you in identifying financing sources.
- Serving as your advisor as you prepare for an IPO or position yourself to be acquired.
- Providing due diligence and valuation services for acquisitions.

If you’d like to contact the nearest PricewaterhouseCoopers’ venture capital expert, please call our Technology Industry Hotline at 1-877-PwC-TICE or visit our Entrepreneur Resource Centre at our Vision to Reality Web site at www.pwc.com/v2r and click on “Find A Professional.”

Conclusion

Venture capital is available to entrepreneurs with an innovative idea and a solid business model. Utilizing your professional network can help get you in the door, but a clear, comprehensive business plan is going to be a determining factor on whether or not you're able to secure funding. Ensure that your financials are realistic and on-target, your management team is solid, and your marketing plan differentiates how your product is superior to that of your competitors. Support all of your assumptions with underlying data and market information, and be prepared to defend your sales projections.

Venture capitalists are not passive investors—they want to see your commitment to the company. They are investing with the expectation of a 30 to 40 percent return on their investment and want to be sure that you and your management team have what it takes to make it through to a favorable exit.

Do your homework to ensure that the firms you approach have expertise in your particular sector. Become familiar with the various structures of VC financing in order to more successfully negotiate the terms of the agreement. And, be prepared to make trade-offs to close the deal. In the end, the entrepreneur and the venture capitalists have the same end goal—to grow a successful enterprise.

Our objective for *Three Keys to Obtaining Venture Capital* is to provide the determined entrepreneur with information about the steps for obtaining venture capital financing. We hope that you find this information helpful in deciding either to move forward in seeking financing from a venture capitalist, or consider other more suitable options. Whatever that path may be, PricewaterhouseCoopers is dedicated to supporting entrepreneurs in their mission by advising them on how they can make their visions become a reality.

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Other Web Sites of Interest:

www.pwc.com/moneytree—For the latest data on venture capital investments in the U.S.

www.pwc.com/nextwave—For venture capitalists and entrepreneurs alike, providing the latest investment data and issues-oriented articles

www.pwc.com/v2r—Our microsite specifically targeted to entrepreneurs and start-up companies

www.barometersurveys.com—A look at how fast-growth companies are planning for the future and what obstacles they're facing

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