

### **GreenHills Ventures – Why NOT to Invest in VC – backed Companies**

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### Dear Colleagues:

Every week we receive articles from wealth management firms, family offices, private bank partners, money managers and institutional investors with insights on the current state of the global economy or trends directly affecting investments in the venture capital and private equity community.

The following article is specific to venture capital investing which have everyone taking special note as it underscores issues involving having a venture capital investment in a start up or early stage company.

"According to multiple research studies, including from the <u>Kauffman Foundation</u>, have shown that when you remove a follow-on venture capital round from a founder or angel investor - funded company, that expected returns skyrocket."

At GreenHills, we believe our multi tranche investment approach builds enterprise value especially when the investment is designed to achieving operational cash flow which almost always propels the company's valuation and positions it for an attractive exit. Our investors and private clients all agree.

# The typical wisdom regarding the appropriate financing course for a new company goes as follows:

- 1. An entrepreneur starts a company in classic "bootstrap" fashion with a combination of sweat equity and their own financial resources. This usually consists of personal savings, credit cards, and small loans from relatives (Mom, Dad, Uncle Bob, etc.).
- 2. Through connections, or through a chance meeting at a networking or social event, an angel investor hears the entrepreneur's story, likes them and their technology, and on the spot, writes a check to provide the company with its first outside financing.

The angel then introduces the entrepreneur to his or her wealthy friends and business connections who, based on the good reputation of the referring angel, also invest.

3. With this seed capital – more often than not totaling between \$100,000 and \$1,000,000 - the company accomplishes a number of key technical milestones, gets a beta customer or two, and then goes on a "road show" to venture capitalists around the country for capital to "scale" the business.

This venture capital financing - usually between \$3 and \$10 million - is the first of a number of rounds of outside investment over a period of three to five years. With this capital, the company propels itself to \$50 million+ in revenues, and to either a sale to a strategic acquirer or to an initial public offering.

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- 4. With the exit, the entrepreneur and the original angel investors become fantastically rich and are lauded far and wide.
- 5. The cycle is then repeated with the original angel investors now joined in their investing by the once impoverished but now wealthy entrepreneur.
- 6. All live happily ever after.

It all sounds wonderful and it is. The only problem is that it is almost always a fairy tale.

What really happens is more like the following:

- A. The entrepreneur pours their lives, their fortunes, and their sacred honor into their company at significant personal sacrifice to them, their families, and everyone connected to the enterprise.
- B. An unexpected investor appears out of the blue and backs the company less impressed by the technology than by the talent, desire, and grit of the entrepreneur.

Technical progress and market traction are much slower and cost a lot more than anticipated.

There are a lot of dark, hard days.

- C. There is considerable internal debate around whether or not to solicit and/or accept outside venture capital. For most companies, it is simply a non-starter. Management has the wrong pedigree, is geographically undesirable, competes in the wrong industry, and/or has a business model that lacks "scalability credibility" with the venture community.
- D. Usually unbeknownst to all, the decision around pursuing or accepting a venture capital round will be the <u>most important factor</u> in determining the investment return for the founder and the original angel investors in the company.

But here is the key – contrary to popular wisdom it is **negatively** correlated.

Yes, you heard me right – multiple research studies, including from the <u>Kauffman Foundation</u>, have shown that when you remove a follow-on venture capital round from a founder or angel investor - funded company, that expected returns skyrocket.

This is very counter-intuitive but critical insight for emerging company entrepreneurs and those that back them to grasp. It is driven by the following:

• The Best Metric for the Health of a Company is Cash Flow. By definition, companies that receive venture capital cannot fund their businesses from operations, and thus need to seek outside capital.

This leads to a lot of negative selection with VC - backed companies — whereby the sample of companies that need venture monies are by definition weaker companies.



• Venture Capitalists Have Very Different Objectives than Angel Investors. Venture capital funds are usually 7 - 10 year partnerships whereby the general partners - the "VC" - manage the capital of the limited partners, usually institutions (endowments, pension funds, etc.).

At the end of the period, all profits and proceeds are distributed to the various partners on a predetermined split. These splits are normally such that the VC needs to obtain a "highwater" return for their limited partners before they, as the general partners, see any return.

In practice, this creates a significant incentive for the general partners to hold on for an extremely large investment return, and to be reasonably indifferent regarding smaller (less than 3x returns).

As a result, the VC will often block a portfolio company from harvesting a very attractive, but not home run, return.

• Venture Capitalists Cut Tough Deals. Venture capitalists for the most part are very nice guys and passionate about entrepreneurship, but they are not shrinking violets. And they hire very aggressive securities attorneys to represent their interests.

This combo all too often leads to various forms of deal unpleasantness, like cram-down rounds, liquidation preferences, and change of control provisions, which in turn, often lead to unhappy founders and angel investors even in somewhat successful exits.

My suggestions for the investors seeking emerging companies to back?

First, look for "one and done" financings - companies that need just one round of outside capital to propel them to positive cash flow.

Second, look for companies that have short and realistic liquidity (exit, IPO) timelines.

And third, don't get star-struck by big venture capital interest in a deal. It is often a double-edged and very sharp sword.

To Your Success,

### **About GreenHills Ventures**

GreenHills Ventures, LLC., established in 2001 as a private investment holding company and General Partners for GHV Fund I and GHV Fund II, (GHV Fund), an early stage venture fund and GHV Wealth Management Holding, LLC. (GHVWMH), a wealth management firm focused on alternative investments for its single and multi-family offices and institutions. For more information visit <a href="https://www.greenhillsventures.com">www.greenhillsventures.com</a>