



VENTURE CAPITAL

A Guide to Understanding Venture Capital



CONNECTING SASKATCHEWAN BUSINESS WITH THE WORLD

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What is Venture Capital

Venture Capital can be defined as an investment, generally in the form of equity, into a new or rapidly expanding business with considerable risk of loss or profit.

Who uses it? Venture Capital is important to a number of businesses at various stages in the business life cycle. Companies that use Venture Capital include:

- Start-up companies
- Companies that are young and currently unprofitable
- Companies that are profitable and require funds for internal expansion
- Companies that want to expand to a new product line or to acquire another company

When do they use it? There are five stages when Venture Capitalists invest. They are at the start-up stage, first stage, second stage, third stage and leveraged buy-outs.

1. ***Start-up Stage Financing*** The companies at this stage are usually less than one year old and have not produced a product or service for commercial sale. Financing is provided to develop the initial product or service and carry out marketing activities. Management teams are generally being assembled or have just been assembled.
2. ***First Stage Financing*** At this stage, financing is provided to companies who lack adequate resources for initial marketing budgets to bring their product to market. At this point, the company has a management team in place, although the company may still not be profitable.
3. ***Second Stage Financing*** is provided for expansion. Usually, marketing and sales are progressing well. However, the company still may not be profitable.
4. ***Third Stage Financing*** Also known as Mezzanine financing, it is provided for major expansion in companies whose sales are increasing, and whose cash flow is break-even or slightly positive. Funds are used for plant expansion, marketing, working capital, or new product development.
5. ***Leveraged Buy Outs (LBOs)*** Financing is provided for the strategic purchase of other product lines, divisions, or companies, or for management/employees to purchase some or all of the company for which they work.

Who are Venture Capitalists

Venture capitalists are companies, individuals or investment pools who provide investment capital, management expertise and experience. Venture Capitalists are looking for a higher rate of return than would be given by more traditional investments. The return on their investment is tied to the performance of your company. The Venture Capitalist may or may not have any applicable industry experience relevant to your business.

Who are Angel Investors

An investor that also acts as a mentor and provides industry expertise is called an “angel investor.” “Angels” are a specific type of Venture Capitalist. They often have business experience relevant to your company and are interested in adding value to your company. They also expect to make a return on their investment. These investors often will sit on the board of directors, provide support to management or suggest appropriate contacts.

They generally are individuals in your community who invest in local businesses. “Angels” want to be part of a new venture and to be involved in the thrill of helping another business succeed. In many cases, the Venture Capital process is something they have experienced with their own company at some point in the past.

Am I a Candidate

There are four key questions entrepreneurs should ask themselves to determine whether their business is acceptable for Venture Capital financing. These questions include:

- Do we have a strong management team in place or nearly in place?
- Does my product or service have potential for capital gain?
- Have I made realistic financial projections and assumptions?
- What is my financial stake in the success of this venture?

The Four Key Elements in Venture Capital Financing

1. **Management** The likelihood of winning a Venture Capital deal depends on the strength of the management and its expertise. Your management should be capable and committed. A well-rounded management team brings significant credibility to the company. Never assume that Venture Capitalists will support you strictly because of strong product sales.
2. **Potential for capital gain** The Venture Capitalist needs an above-average rate of return compared to other investment instruments. The earlier you are in the business cycle, the higher the rate of return the Venture Capitalist will need to compensate for the increased risk of investing in a new company. While these rates may seem high, the Venture Capitalist assumes a great deal of risk by investing in your business. Return On Investment (ROI) is discussed in further detail later in this document.
3. **Realistic Financial Requirements and Projections** The Venture Capitalist will probably adopt a very conservative view of your company, so be realistic in your financial assumptions. Emphasize your total financial requirements for each specific stage of growth. The ability to realistically state your financial requirements will demonstrate your ability to plan properly.
4. **Owners Financial Stake** *An important indicator of management’s commitment to the business is the personal financial resources committed to the company. If the Venture Capitalist is*

going to commit resources to your company they must be sure that the owner is committed. This financial commitment is a strong indicator of your desire to see the business succeed.

How do I Obtain Venture Capital Financing

There are five recommended methods for accessing Venture Capital. Regardless of the method, the most crucial step of the process is to ensure that your business plan is up to date. The business plan will always be requested prior to any face-to-face meetings and is discussed further in this guide. If you are successful in getting a meeting be prepared. You usually have only one opportunity to sell them on your plan. Rarely are there second chances.

The methods of obtaining financing are:

1. ***Through a Referral*** One way to access Venture Capitalists is through a referral from professionals such as accountants, brokers or other industry specific professionals. Taking the opportunity to network with professionals and Venture Capitalists will provide the greatest chance for your business getting a fair look.
2. ***Make a Contact with Former Venture Capital Recipients*** A good source may be other business owners that have been successful in gaining venture capital funding. They may provide appropriate contacts and advice on how to approach the process.
3. ***Attend a Venture Capitalist Meeting or Conference*** Generally, agreements are not made at this stage. However, it is an important tool for setting up other meetings.
4. ***Contact the Venture Capitalist*** It is suggested that you do some research on what type of investments this investor is interested in. Many Venture Capitalists look to invest in a particular industry or sector they know well. If there is interest, the investor will request a copy of the business plan. Be prepared to answer many questions as a part of the screening process.
5. ***Speak to your local Business Banking representative.*** Most of the major Canadian Financial institutions have Venture Capital departments for certain stages of investment.
6. ***Send an Overview of the Business Plan*** This method is generally the least effective manner of getting noticed. If you choose this method make sure to include a personalized cover letter.

The Business Plan

As stated briefly in the above section, the most important document that the Venture Capitalist requires is the business plan. The business plan is seen as a reflection of the company and indicative of the dedication and knowledge of the management team.

A business plan prepared for a Venture Capitalist will differ from a business plan for your bank or internal company use. The following are some key points to keep in mind when preparing your business plan for Venture Capitalists:

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- The Venture Capitalist will want to know exactly how much money your company requires and how you intend to use it.
 - The Venture Capital business plan must entail the company's vision, future goals, a realistic financial plan, and how management will help the company achieve its financial goals.
 - The Venture Capitalist will want to understand how your company intends to repay the investment and what the exit strategy will be.

Ernst Young outlines several mistakes and good practices in developing a business plan for Venture Capitalists. Some of the following common mistakes and best practices are included and are based on their experience in raising Venture Capital.

Best Practices:

- Accentuate the excellent management team
- Tell-it-all executive summary
- Market research
- Use a strong writer from the management team
- Timeline charts and action plans
- Outline how the investor will profit and the exit strategy
- Use of graphics and charts

Common Mistakes:

- Invalid or unsubstantiated assumptions
- Overly optimistic projections
- Only including financial data
- Inconsistencies between text and projections
- Unprofessional document - poor organization
- Too much/too little detail
- Underestimating capital requirements
- Underestimating the competition

Speak to your accountant to review your business plan and any input they may have in regards to your financial statements, projections and valuations.

Venture Capital Approval Criteria

The approval process for Venture Capital financing is difficult. It is estimated that Venture Capitalists invest in only 1% or 2% of the deals that they examine.

In a past study Venture Capitalists stated that the most important criteria to ensure the approval of a deal was the entrepreneur's expertise in their business area. The second most important criteria was a strong commitment and drive in their business. The third involves the entrepreneur's ability to assess risk and respond accordingly. Fourth on the list was availability of a prototype so the Venture Capitalist is not left to guess at what might be or look like. The fifth criteria most Venture Capitalists ask themselves was "are the entrepreneurs leaders?" After these preliminary questions have been asked, then the Venture Capitalist will assess market growth and product potential.

The study states other important areas include the ability to communicate, the entrepreneur's track record, and attention to detail. Also listed were potential market acceptance, liquidity, patent and copyright protection and return on investment. A summary is below. Always remember to consider these points and ensure they are covered in your business plan.

Summary: Venture Capitalist's Criterion for Approval:

- Entrepreneur's expertise in the industry
- Strong commitment to their business, products or service
- Entrepreneur's ability to assess risk and respond accordingly
- Availability of a prototype
- Leadership ability of entrepreneur
- Potential for market and product growth

Terms of Venture Capital Agreements

Length of the Agreement

Venture Capital investments tend to have a mid to long time horizon which can range from 3 to 10 years in length.

Exit Strategy

There are two preferred ways to exit a Venture Capital agreement. The exit strategy is an integral aspect of the business plan. The strategy must be scrutinized long before financing will be granted by the Venture Capitalist. The optimal method of exit depends on a number of factors. There are two favored options are to find a buyer for the company, or take the company public through an Initial Public Offering (IPO). Depending on which option is selected, all formal relationships may be severed unless both parties decide otherwise.

1. ***Find a buyer for the Company*** This option can take a number of forms including selling to a competitor, the original entrepreneur buying back ownership, or being acquired by another company.
2. ***Initial Public Offering (IPO)*** The IPO exit strategy is almost always the preferred method to end the agreement. This option will provide the Venture Capitalist with an equity position in the company for which they have several options. Their first option is to capitalize their equity position, thus effectively ending the investment. Another option is for the Venture Capitalist to

maintain their equity position in the company and become a shareholder just like any other. Venture Capitalists will remain in a minority equity position when they feel there is a continuing opportunity for high returns.

Expected Return On Investment (ROI)

Over the course of the investment, Venture Capitalists may expect returns ranging from 25-50% compounded annually. The rates expected for the investment vary depending on what stage of financing your company requires. As the risk of the investment decreases, the required rate of return also decreases. For example, start-up financing looks for 40-50% return, second stage expects 30-40% and third stage requires 25-30%.

These returns are considered high compared to other traditional investment standards, for example savings accounts, investment grade bonds, mutual funds or blue chip stocks. However, higher returns are required by Venture Capitalists since a large number of investments are unsuccessful. There is need for a high rate of return since the investment carries a high level of risk and exposure, is locked in for a long period of time and offers no interim repayment.

In general the higher the risk, the higher the required ROI.

Additional Roles of the Venture Capitalist

Several roles exist for the Venture Capitalist other than simply providing financing. Some roles that Venture Capitalists may want to participate in include becoming a Member of the Board of Directors, taking a Management Position, or giving influence in recruitment decisions.

Board of Directors

Most Venture Capitalists will insist on becoming a member on the Board of Directors. It is important to assemble a strong Board of Directors that can provide expertise and guidance for the management team. The Board, if chosen correctly, can bring a great deal of experience to the company in its initial and growth stages.

The length of partnership and the degree to which that relationship continues after the exit strategy is up to the entrepreneur. In certain cases, Angel Investors remain on the Board of Directors or in management. In other cases, all ties are severed.

Management position

It is not common for traditional Venture Capitalists to request a management position. However, in terms of an "Angel Investor," it is far more common and often encouraged. The "Angel" chooses to invest in the company because they often share a common expertise with the venture.

Their expertise is seen as invaluable for the success of the venture. Often "Angels" have held similar positions, are familiar with the Venture Capital industry, and are known within and respected in their field.

Influence in recruiting new staff/management team

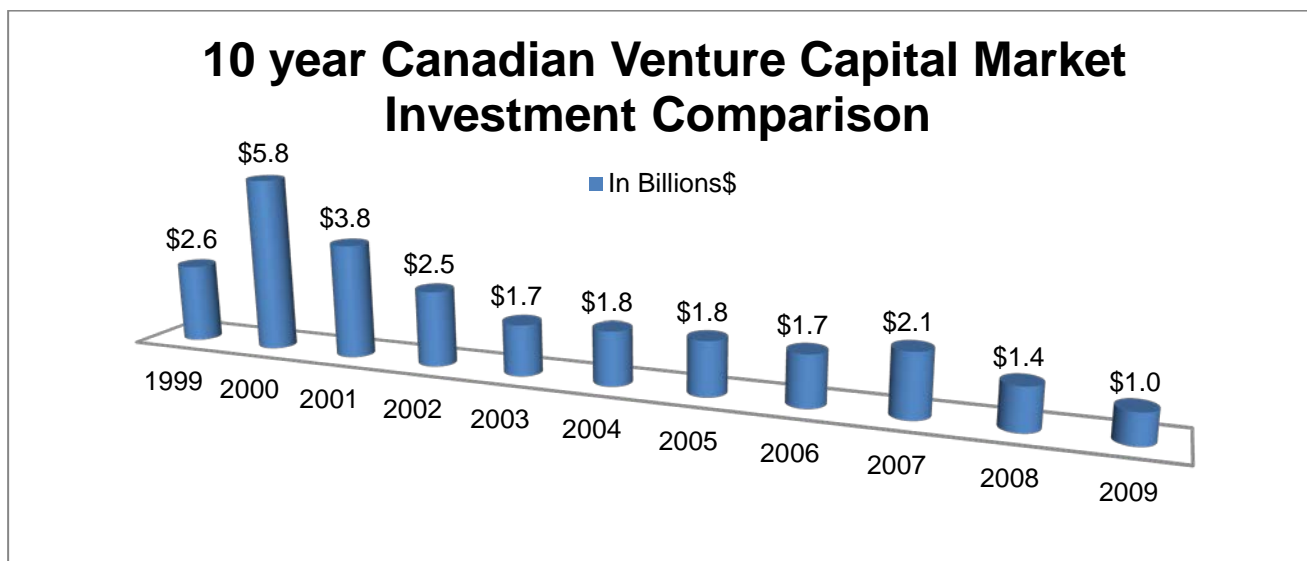
There is immense pressure on the entrepreneur to ensure that a qualified management team is in place during high growth periods. The pressure is felt particularly when the entrepreneur is an inventor, engineer or scientist. In many cases, the entrepreneur will agree to pass on the responsibility of the day-to-day activities.

Appendix

The Current Canadian Venture Capital Market

According to the Canadian Venture Capital Association (CVCA) a total of \$1 Billion was invested throughout Canada in 2009. This amount is down from the approximate \$1.4 billion invested in 2008. This level of Venture Capital funding is also the lowest since 1996.

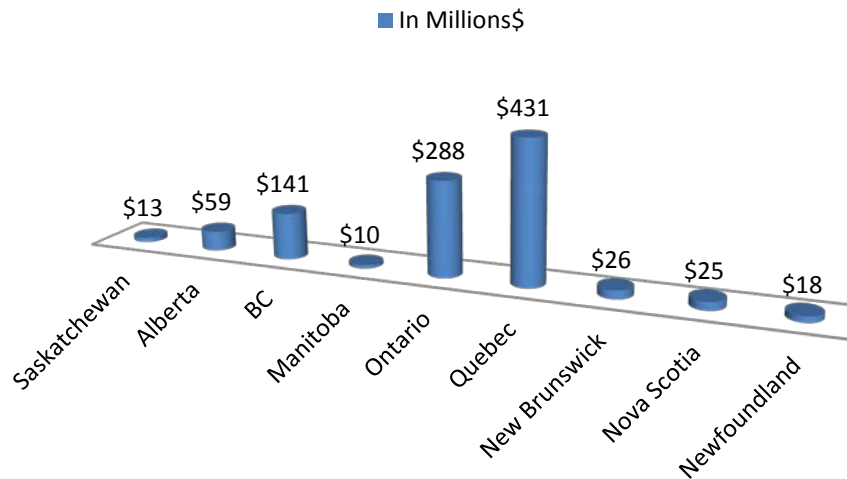
In 2009 a total of 331 Canadian companies received Venture Capital funding which was again down from the 338 companies that received funding in 2008.



The reduced levels of Venture Capital funding in Canada essentially mirrored the trends in North America and around the globe. The United States Venture Capital market decreased by 37% in 2009 to \$17.7 billion invested in 2368 companies. American Venture Capital funds and other foreign investors accounted for 30% of the total Venture Capital funding in 2009.

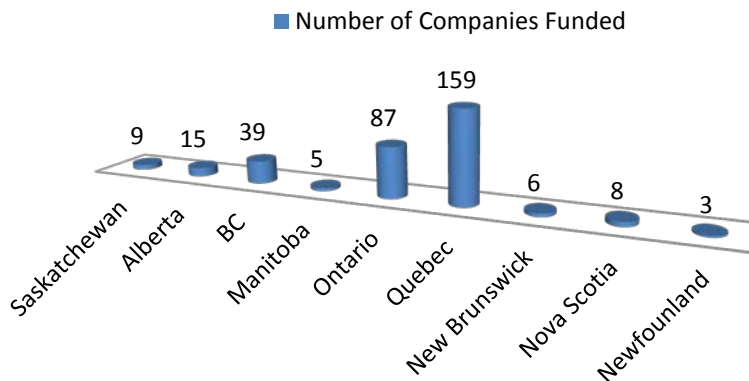
Of the approximate \$1 billion invested in Canadian Venture Capital investment in 2009, Saskatchewan had approximately \$13 million in financing. Quebec experienced the highest amount of Venture Capital investment with over \$431 million in deals. Ontario had the second most at \$288 million.

Total Dollars Invested by Province in 2009

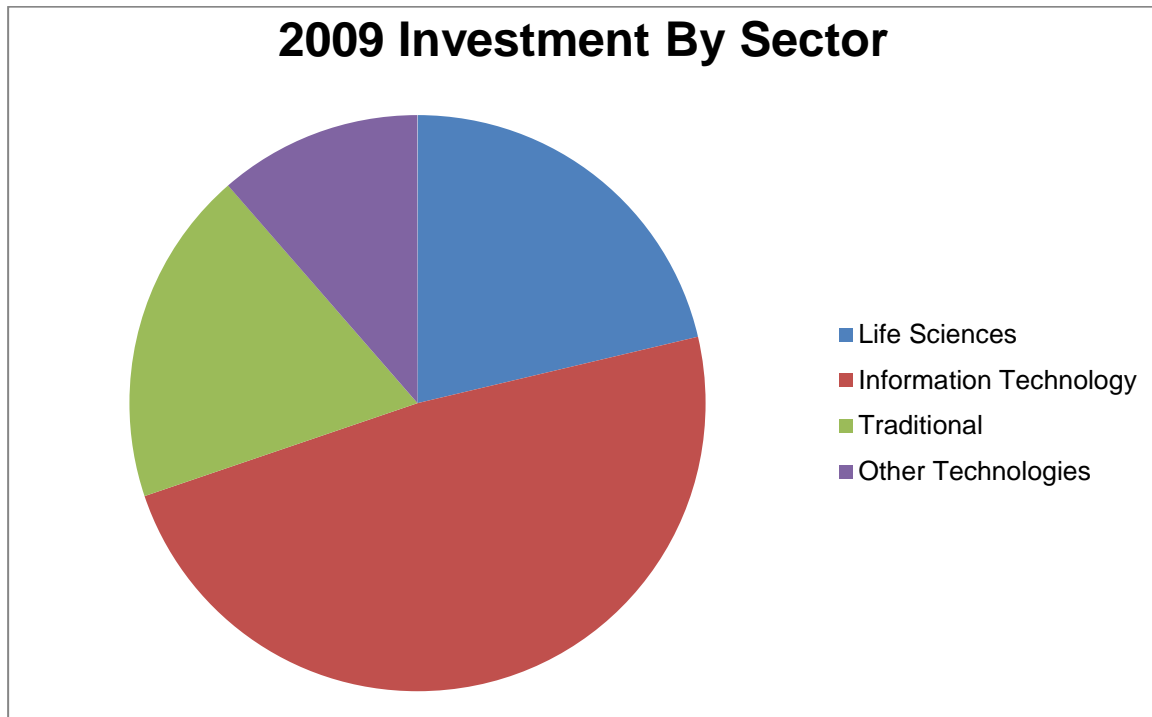


Not surprisingly Quebec also had the highest number of companies that received Venture Capital Financing. Quebec was followed by Ontario and British Columbia. Saskatchewan had at total of 9 companies financed with an average deal size of \$1.4 million.

Number of Companies Funded by Province in 2009



The industry of choice for Venture Capital investment in 2009 was Information Technology with almost 50% of total investment given in this sector. Within this sector almost \$180 million was invested in Communications and Networking. Biopharmaceuticals also represents a significant amount with over \$177m in Venture Capital Financing.



Detailed 2009 Venture Capital Investment by Sector

Sector	\$ Invested In Millions	# of Companies
Life Sciences	\$215	57
Biopharmaceuticals	\$177	39
Healthcare	\$2	1
Medical Devices and Equip	\$27	12
Medical/Biotech IT	\$9	5
Information Technology	\$489	129
Communications/Networking	\$180	18
Electronics and Computer Hardware	\$43	16
Internet Focus	\$52	35
Other IT Services	\$3	2
Semiconductors	\$69	11
Software	\$142	47
Other Technologies	\$115	29

Energy and Environmental	\$102	21
Other Technologies	\$14	8
Traditional	\$190	116
Consumer/Business Services	\$86	39
Consumer Products	\$8	11
Manufacturing	\$64	48
Miscellaneous	\$32	17
Retailers	\$.6	1

The statistics for the appendix were compiled from information from the Canadian Venture Capital Association (CVCA). Founded in 1974, the Canadian Venture Capital Association is the primary association for Capital Venture professionals and information in Canada.

According to the CVCA, its mandate is to promote networking, communication, research and education, and many other issues within and outside the Venture Capital industry.

The association represents nearly 100 Venture Capital members in Canada. Their members include private firms, government investment bodies and large financial investors across technology and traditional industries.

Saskatchewan Venture Capital Contacts

Canadian Venture Capital Association

Phone: (416) 487-0519

Fax: (416) 487-5899

Website: www.cvca.ca

The CVCA has an extensive directory of Canadian companies involved with Venture Capital financing. Most of the large Canadian banks have active Venture Capital Investment teams. Below are some additional companies or organizations involved with Venture Capital Financing within Saskatchewan.

Westcap Mgt. Ltd.

www.westcapmgt.ca

PFM Capital Inc.

www.pfm.ca

BDC Venture Capital

www.bdc.ca

Golden Opportunities Fund

www.goldenopportunities.ca

Saskatchewan Trade and Export Partnership

Phone: 306-787-9210

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