

INTELLIGENCE

- News & Views
- Features
- Roundup
- Events
- Research
- Jobs

KNOWLEDGE BANK

- Learning Curve
- Surveys
- Leading Edge
- Glossary
- Fund Links

SECTOR ANALYSIS

- Case for Countries
 - > North America
 - > Western Europe
 - > Central & E. Europe
 - > South & C. America
 - > Middle East & Israel
 - > Africa
 - > Australasia
 - > Asia
- Case for Sectors
 - > Industry Sectors
 - > Private Equity Sectors

CASE FOR SECTORS

SECTOR ANALYSIS

[Click here for printer friendly page](#)

Are venture capitalists seeking control of your company?

27/09/2005. Source:First Capital Group. Jeffrey P Blanchard

At the initiation of any deal, the percentage of ownership the venture capital firm purchases in an investment transaction is a function of the real or perceived value of the company, says Jeffrey P Blanchard.

For instance, if Company A seeks \$5 million in funding, and the investors determine that the existing pre-investment value of the company is \$5 million, then the total value (the pre-investment value plus the capital raised) equals \$10 million. In this example, the \$5 million the company is seeking in investments will purchase approximately 50% of the company, meaning that the venture capital firm owns half of the company. The math is straightforward and unchanging.

Obviously, there is more to the investment decision than determining an equitable valuation and purchase price. The venture capitalist must be convinced that the growth potential of the company will result in an ultimate return on the invested capital that is commensurate with the risks to which the capital will be exposed in making an investment decision. If the expected returns do not meet the venture capitalists' minimum return requirements, the choices are to either not make the investment or purchase the securities of the company at a lower price.

An expression that we follow in our investment negotiations and decisions is that "There is no such thing as a good one-sided deal." If the transaction is unfairly favorable to the venture capitalist, there is a serious risk of stifling the entrepreneurial enthusiasm. On the other hand, a proposal that is overly favorable to the company will generally not result in any funding.

Over the last 10 years, we have seen the size of venture capital rounds increase from about \$3 million to \$5 million, to an average of \$10 million to \$15 million. For an early-stage company, whose pre-money value is less than the amount of capital being raised, the venture capital investors will generally end up owning a majority of the company. Period.

The conundrum is this: Entrepreneurs often need substantial funding, yet they do not want significant dilution of their ownership interest.

The solution, fortunately, is also straightforward. And it's in your hands.

Just as people don't buy 100% of the gas for a trip from Florida to California at the outset, choosing instead to purchase enough for each leg of the journey, it's a time-tested strategy to devise a business plan that requires less capital initially, with additional capital arriving as the company executes its business plan and demonstrates its success.

This graduated strategy, based on its interim successes, positions the company to raise subsequent amounts of capital. If the company is successful at each interim step, the valuation of each successive round will be at higher valuations; therefore, there will be less dilution of your ownership and you will retain greater control over your company.

(Caveat: It is important to point out that raising capital is very time consuming and can be a major distraction to management. Therefore, a company should avoid raising too many small rounds of capital that they ignore their primary responsibility of managing the firm.)

Many of our portfolio companies have done this successfully. In one such case, we initially invested \$2.5 million at a pre-investment value of \$7.5 million. We invested a second time in a \$5 million round at a pre-investment value of \$20 million. The final round involved new investors providing \$10 million at a pre-investment value of \$50 million. As shown in the figures below, the founding management team was able to maintain a majority ownership position until the third round.

	Round 1		Round 2		Round 3	
Amount Invested	\$	2,500,000	\$	5,000,000	\$	10,000,000
Price per share	\$	1	\$	2	\$	4
Pre-Investment Value	\$	7,500,000	\$	20,000,000	\$	50,000,000
	Shares		Shares		Shares	
Founders	7,500,000	75.0%	7,500,000	60.0%	7,500,000	50.0%
Round 1 Investors	2,500,000	25.0%	2,500,000	20.0%	2,500,000	16.7%
Round 2 Investors			2,500,000	20.0%	2,500,000	16.7%
Round 3 Investors					2,500,000	16.7%
	10,000,000	100.0%	12,500,000	100.0%	15,000,000	100.0%
Post-Investment Value	\$	10,000,000	\$	25,000,000	\$	60,000,000

In summary, most venture capital firms are not seeking a controlling interest in their portfolio companies, though when they acquiesce to high up-front investment requests from entrepreneurs, that's often the result. But nearly all venture capital firms are pleased to provide incremental investments that allow the portfolio companies to demonstrate successes, retaining the entrepreneurs' control and ownership. After all-if you succeed, the venture capital firm does, too.

First Capital Group is a venture capital firm that invests in a diversified portfolio of well-managed early and expansion-stage companies primarily in Texas and the Southwest, working with their management teams to help build value. As one of Texas' most established venture capital firms providing funds to this traditionally under-served market segment, First Capital Group delivers more than 75 years' combined experience to assist entrepreneurs in obtaining the capital they require to execute their business plans and the experienced counsel they need to help achieve their business objectives. Jeffrey P. Blanchard launched the San Antonio-based firm in 1984, having already held senior management positions in two other such firms. First Capital Group has consistently remained focused on a diversified investment strategy, enabling it to meet investors' needs for a lower-risk portfolio without compromising expected investment returns. First Capital Group originates and serves as a lead or principal investor in all of its transactions. For more information, please visit: www.FirstCapitalGroup.com