Venture Capital, Private Equity & My SME

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WHO IS AN ENTREPRENEUR ?

- Entrepreneurship, in its narrowest sense, involves conceptualizing innovative ideas, converting them into products and/or services and then building a venture to take the products/services to market thereby recovering costs and earning profits.

- Any person engaged in entrepreneurship is an entrepreneur

- The key elements of entrepreneurship include **Innovation, Risk Taking, Pro-active View, Focus Resilience and Discipline**
- **Delayed Gratification is part of the elements**

THE PERSONALITY TRAITS OF AN ENTREPRENEUR

- Character/Integrity
- Courage
- Decisiveness
- Affability
- Dignity
- Enthusiasm
- Prudence
- Honesty
- Discipline
- Modesty
- Sincerity
- Patience
- Punctuality
- Cheerful Disposition
- Courtesy
- Emotional Control
- Temperance & Tolerance
- Focus
- Innovative
- Goal Setting

Characteristics of SMEs

- Ease of entry and exit
- Limited access to finance
- Mainly local resources (low import content)
- Simple and linear technologies
- Mostly labour intensive
- Prevalent in manufacturing than in service sector
- Informal relationship between employees and employer
- Fusion of both ownership and management into one person or individuals
- Exist mainly in form of sole proprietorship and partnerships but increasingly limited liability companies lately

Importance of SMEs

- Stimulation of indigenous entrepreneurships
- Offer greater employment generation per unit of invested fund
- Development of local technologies
- Achieve industrial dispersion
- Moderate rural-urban drift
- Mobilization of domestic savings
- Generate industrial linkages
- Production sectors serve as import substitution
- Provide good value chain for poverty alleviation
- Provide variety of choice for consumers
- Provide training medium for local entrepreneurs

Problems of Raising Finance for SMEs

- Less attractive to institutional investors
- Higher interest rates due to perceived risks
- High costs of lending including hidden costs
- Lack of adequate collaterals
- Not qualified for capital market (cannot afford it)
- Inability to satisfy lending conditions
- High possibility of loan misapplication
- Poor loan repayment records
- Competition for funds with less risky sectors

Sources of Funds for SMEs

- Personal Savings
- Retained Earnings
- Overdraft
- Trade Credits
- Leasing
- Sale and Lease Back
- Term Loan
- VENTURE CAPITAL

Factors Affecting Choice of Financing

- Length of the Project ✓
- Pattern of Cash flow
- Risk Profile of the Project
- Cost of Finance
- Existing Shareholders
- Existing Assets
- The Need for future Finance

Attracting Attention to Financiers

- Prepare Good Business Plan
- Ensure adequate knowledge in the sector
- Be extremely transparent
- Prepare to dilute ownership
- Plan to produce marketable and qualitative products/services
- Strengthen management with professionals
- Be receptive to ideas and changes
- Ensure proper book keeping
- Develop good marketing strategies
- Deploy modern technologies in production
- Develop good corporate plan and governance

A Word On Business Plan

For SMEs, a Business Plan is a looser with any VC if…

- Projections are in Billions
- The BP weigh more than a Yellow Page
- There is no competition
- The BP is prepared by a job-seeking 'consultant'
- The fund request is in billions
- The BP starts with 'Dear Sir'
- All the management staff are unemployed
- You cannot identify the products or services after reading Executive Summary

Criteria For Entrepreneurial Excellence

- Leadership
- Strategic Planning
- Customer And Market Focus
- Information And Critical Analysis
- Adaptive Human Resources
- Process Management
- Business Result And Feedback

Venture Capital Financing

- History
- Few points Upfront
- Venture Capital Defined
- Characteristics of Venture Capital
- Venture Capital Life Cycle
- The Deal process
- Due Diligence Defined
- Pre-Due Diligence
- Post-Due Diligence
- Advantages of Venture Capital Financing
- Venture Capital Downsides
- Preparations for Venture Capital Funding
- Challenges of Venture Capital Funding in Nigeria

History

Venture Capital discovered America and this tradition continues:

- Queen Isabella of Spain backed Christopher Columbus financially in April 1492 to finance a west bound expedition to the New World.
- After countless rejections but 'fired' by entrepreneurial resilience, Columbus approached Isabella who agreed to the deal but with a caveat documented through a signed contract. The terms of the contract were:
  - **Participatory Management**: Columbus was to become the governor of all territories he located – Effective hands-on approach and monitoring
  - **Succession Plans**: There should be included in his governance a hereditary peerage – Continuity and safety of her investment if anything happened to Columbus
  - **Distribution and Carry**: One-tenth of all precious metals found within his jurisdiction should belong to her and her family

In honoring the terms of the contract, Columbus went a step further.

- **Management:** During the second voyage in 1493, he established the Colony of Isabella which became the first settlement of Europeans in the New World and these Europeans paid taxes to Columbus.
- **Income Streams:** Though she rejected the act as bestial, Columbus dispatched shiploads of slaves back to Spain to serve Isabella.
- **Continued Income Streams:** Between 1492 and November 7, 1504, he made several trips to the New World and returned substantial gold and other precious stones to the Queen.
- **IRR --->∞:** Both the venture capitalist (Isabella) and the promoter (Columbus) died very rich with stupendous wealth left behind.

A Few Points Upfront about Venture Capital

- Venture Capital Has Very Little to Do With Traditional Banking
- Venture Capital is not a 'Cowboy Financing'
- Venture Capital is a Value-Added 'Capital Plus…' Financing

Venture Capital

Drives
- New Industries
- Start-Ups
- Seed Capital
- Expansion Capital
- Replacement Capital
- MBOs

Is
- People Business
- Pedestrian Business
- Growth-oriented
- Exit-oriented

Is
- Very Risky
- High Return
- Creates Wealth

Value-Added 'Capital Plus…' Financing Concept

- A much closer relationship between a VC and investee company usually not seen in classical financing
- A partnership arrangement equivalent to a business partnership and joint decision
- The "Plus" offers the company an additional service, hand-holding and helps to overcome deficits in managing the company and also solves problems which might otherwise endanger further positive development and growth of the company
- The "Plus" forces the venture capitalist to pay much more attention to his investee company and the performance of his investment, compared to an investment in a listed company
- Joint decision mostly prevalent in addition to shared risk/reward tradeoff.

Venture Capital Defined

Traditionally, Venture Capital refers to funds provided by the professionals (VCCs) who invest alongside management in rapidly growing companies that have the potentials to develop into significant economic contributors.

It involves searching for investment opportunities capable of generating considerable economic value and substantial returns to the investors and as such it involves unsecured investments, mostly in equity and at higher than average risk.

These invested funds have a time horizon at which the investor will exit from the investee company

Venture Capital Defined

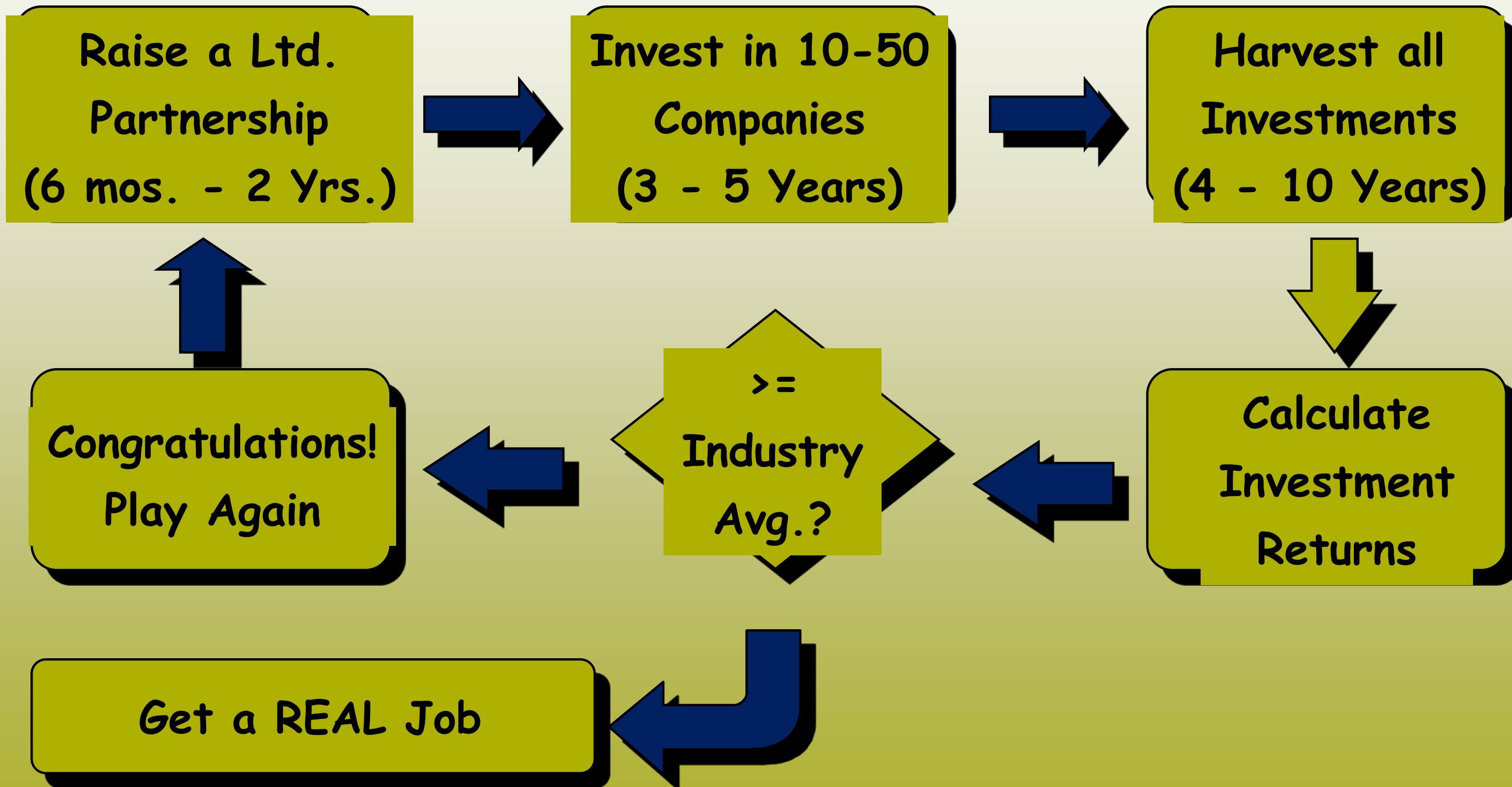
Venture Capitalist generally

- Finances new and/or growing companies
- Purchases equity/shares in existing firms
- Assists in the development of new products, services and industries
- Adds value to the company through active participation
- Takes higher risks with the expectation of higher rewards
- Develops a long-term orientation to his investments
- Divests after recouping the initial investment with appreciable premium

Characteristics of Venture Capital

- An equity participation through either a direct purchase of stock or through convertibles.
- A long term investment regime that requires a wait period of between 5 and 10 years for investment to provide return.
- An active, on-going involvement by the Venture Capitalist who brings personal value added concept to the investment.
- Each venture capital operations must be predicated on the following:
  - Hands-on approach
  - High growth potentials investee (Low Hanging Fruits)
  - Specialized skills
  - Private ownership/management
  - Schemes allowing for profit sharing, in addition to dividends, large inflow of deals, long term horizon and
- Finally Exit Mechanism

Venture Capital Life Cycle



The Deal Process

The Venture Capital Investment Process is basically in three stages:

- Pre-Due Diligence Process
- Due Diligence Process
- Post-Due Diligence Process

Due Diligence Defined

- Due Diligence in Venture Capital refers to several courses of action, first designed to avoid litigation and risk on the long run, second to determine the value, price and risk of a transaction, and third to confirm various facts, data and representations as contained in the BP which enhance the integrity of transactions between willing parties prior to investment in a project.
- Categories of Due Diligence include
  - Legal due diligence
  - Financial due diligence
  - Operational Due Diligence
  - Technical Due Diligence
  - Environmental Due Diligence
  - Integrity Due Diligence
  - Cultural Due Diligence
  - Commercial Due Diligence
  - Money Laundering/Terrorist Financing Due Diligence

Pre-Due Diligence Process

- Analysis of business plan
- Meet management and visit facilities
- Perform desk study of market - competitors, customers, etc
- Close deal subject to outcome of due diligence, Term Sheet
  - Determine financing structure
  - Funding requirements
- Conduct detailed due diligence

Post-Due Diligence Process

- Valuation
- Negotiations
- Final Closure

Advantages of Venture Capital Financing

- Financial Advantages and
- Operational Advantages

Financial Advantages

- Collateral/Security
- Interest Rate
- Repayment
- Cost of lending
- Less restrictive covenants
- Fund misapplication low
- Easy access to additional funding
- Dividend is not mandatory

Operational Advantages

- Joint Decision Making
- Shared Risks
- Leveraging On Financing Competence Of Investor
- Enhanced Corporate Governance
- Increased Networking (Synergy Advantage)
- Increased/Wider Perspective
- Stronger Internal Control Systems (CFOs)
- Increased Going Concern Status Even After Exit
- Increased Credibility And Prestige

Venture Capital Downsides

- Strange Bed Fellows
- Loss Of Independence
- Possibility Of Being Fired
- Unassured Exit Route
- Exit Valuation May be Outrageous
- Some Restrictive Policies e.g.
  - » Dividend Payments
  - » Anti-dilution
  - » Liquidation Preferences
  - » Participative Preferences
  - » Mandatory Redemption
  - » Approval Rights

Preparations for VC Funding
(What VCs Look Out For)

- Serious Home Work
- Audit Your Inherent Skills
- Re-assess Your Integrity And Transparency Quotient
- Candidly Assess Your 'Financeability' (Prior Financing, Counterpart Fund, Sweat Equity)
- Assess Your Weaknesses And Shore Them Up
- Well Written And Re-written Dynamic Business Plan
- Product Or Service Must Be Clearly Identified
- Management Team Description ("VCs Bet More On The Jockey Than The Horse"
- Market Opportunity (Size, Characteristics, Customers, Distribution Channels)
- Proprietary Aspects/Barriers To Entry
- Competitive Landscape & Positioning
- Economics Of Your Deal (Valuation Range, Size Of Financing Round, Prior Investors, Etc.)

Challenges of VC Funding in Nigeria

- Integrity And Transparency Deficit
- Low Trust Level
- Reluctance To Dilute Ownership
- Amorphous Skill Set
- Hazy Exit Strategies
- Lack Of Corporate Governance
- Incoherent Policy
- Currency Risk
- Access To Possible Future Debt
- Arduous And Tortuous Legal Coverage

Practical Reasons for Rejection by VCs

- Business Plan Challenges
- Observed Integrity/Transparency Issues
- Low Counterpart Fund Contribution
- Inadequate Skills an High Keyman Risk
- Management Challenge
- Agreement Challenges (Term Sheet, SHA etc)
- Market Opportunity Not Big Enough
- Significant Competition
- VC Portfolio Effects – VC Already Has Exposure To The Sector
- VC Doesn't Understand Your Sector And Can't Add Value
- Risk/Reward Mismatch
- VC's Plate Is Too Full

When VCs Turn You down!!

- Don't Be Combative, Hostile Or Belligerent (You May Still Pass This Way)
- ALWAYS Ask The VC
  - The Reason(s) They Chose Not To Proceed;
  - Listen,
  - Learn
  - Don't Be Defensive Or Apologetic
  - Ask For Advise And/Or Suggestions Regarding Whom Your Project Might Be More Appropriate
  - Keep In Touch

Thank You

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