

Conference - HI TECH 1984

Wednesday, October 24, 1984

Introduction

(If flowery)-okay to breathe that smoke, just don't inhale.

First, I want to compliment the National Science Foundation and particularly, Roland Tibbetts, together with the Department of Energy and the government agencies that are participating in this conference, for making a real contribution, not only to the technology based small business community, but also, through their support of the SBIR program, helping to unleash creativity and entrepreneurship in this country. *FRANKLIN JEFFERSON AWARD.*

One of the ~~great~~ forces stimulating new technology in this country is venture capital. I don't come to you as the most experienced venture capitalist nor even with as much experience as at least three of my partners.

Instead, I come to you as a past recipient of venture capital. Having had a venture capitalist on my board of directors for twelve years, I would like to break down some of the myths about the subject and allow you to judge whether or not venture capital is a financial mechanism suitable to your kind of company.

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Let me bracket the term venture capital if I may so that we are at least relating to the same definition.

Venture capital normally refers to a high risk, long-term investment in the ownership or equity of a business. A private investor, using his own funds, may well be considered a venture capitalist if he makes a business of investing in small, high risk companies. The concern I would have is that unless the investor is operating from a large pool of funds over a number of investments, he is likely to want some cash flow and more likely to want a payoff from his investment in a shorter term than is reasonable.

In other words, just about the time you need major financing to really develop your marketplace, your key investor is looking for liquidity. The two often do not go together.

Perhaps the most common venture capital source has been the SBIC or Small Business Investment Corporation. The SBIC is a mechanism by which an individual or group of individuals can put together an equity pool of a minimum of \$500,000 and make application to the SBA for a charter. Granting this, they then have an opportunity of borrowing from the SBA at ten-year government rates, additional funds equal to as much as three times their original investment.

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Usually, the smaller SBICs need to support their administration costs and therefore, often make investments initially as convertible debt instruments to provide an interest income. There are about 500 SBICs operating in the United States with a few managing portfolios in excess of \$100,000,000. The average size would probably be in the range of \$1 to ~~\$2~~ million. A variation of the SBIC is called a MESBIC or Minority Enterprise Small Business Investment Corporation. This program works almost identical to the SBIC program except that government borrowing and other considerations are somewhat more liberal.

Studies have shown that professionally managed venture-backed companies have performed six to ten times better than the average small business.

Another form of venture financing is by major corporations which have established their own venture capital pools. The objective of these major corporations, in addition to a return on equity for their investment, is to get a "window on technology" of new products that may have the potential of becoming future independent divisions or subsidiaries of the parent company.

*PHASE II AWARD WINNERS —
MIGHT FIND ONE OF THOSE FIRMS WILLING TO MAKE
THOSE NECESSARY LETTERS OF COMMITMENT.*

The more common profile of the larger venture funds is in the form of a limited partnership with a ten year limited life. Our fund, The Columbine Venture Fund, is a typical example of what is normally referred to as an Institutional Fund. We are a limited partnership with 32 investors averaging a little more than \$1,000,000 a piece. The minimum size investor is \$500,000. A profile of investors, typical of our fund, would include 30% from pension funds, 30% from insurance companies, 30% from major corporations and the balance of approximately 10% from private investors. In recent years, more and more foreign investors are participating. In our case, 18% of our funds come from either Japan or Europe.

That is a very broad brush of the types of venture capital available.

Although venture investments have been made for centuries, such as Queen Isabella investing in Columbus' voyage to the new world, the venture industry as we know it today is quite young. As late as 1974, there was as little as \$10,000,000 of new money going into the venture capital industry as compared to 1983 where there was over \$3.5 billion. Today, there is over \$12 billion of venture capital under management in the U.S.

*IN OUR PORTFOLIO LUCK PLAYS A BIG ROLE,
LUCKY OR SMART - CHOOSE LUCK - PREPAREDNESS
ANTICIPATING OPPORTUNITY.*

*A NUMBERS GAME - OUT OF 23 COS. -
1/3 - 1/3 - 1/3 + 1 BIG ONE. "MANAGEMENT WAS BEING
STUPID" -*

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Following that industry overview, let me get back to specifics.

One of the great fears of a small business person in approaching any financial institution is the fear of losing his or her company, or at least giving up too much.

Those fears were my fears back in 1965.

In trying to improve performance of a ^{HIGH VOLTAGE} static neutralizer, we accidentally discovered how to make an ionization smoke detector. After the euphoria of believing we had made a great discovery, we found that a company in Switzerland, not only had made an ionization smoke detector, but had been making them for some 20 years. Our design was so far different, ^{HOWEVER,} that we decided to develop a product for the commercial market.

In the fire alarm industry, no product is accepted without certain Underwriters' Laboratories or Factory Mutual Laboratories approval. The approval process took almost a year and drained my resources, forcing me to sell 52% of this new company.

After we had been in and out of solvency for a year and a half, Honeywell, a company that had been watching our development, offered us a three year contract for the first 15,000 units ^{TO BE} private branded. At this point, we had all the elements except the capital to buy the raw materials, the capital equipment, the space, the people and the receivables. In other words, we had no operating capital but instead had about \$75,000 of payables. The company that owned 52% of our stock wanted out.

At that point, I found Central Investment Company, an SBIC, and probably the first in Colorado. After an agonizingly long two months, they offered \$250,000 in the form of a five year loan at 8% (the going rate was then 5%). They also received warrants to purchase 49% of the company at \$1 per share. We made a deal. After buying back the ownership of the company for \$150,000 and paying off part of the debt, I had about \$40,000 of operating capital and a heavy debt load.

This is where the value of the venture capitalist really came into play. This man became a member of our board of directors and encouraged us to maintain a level of discipline, both in the focus of our product development, our administration, our corporate records and our finances.

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When we were desperate for additional funds in 1970 to introduce the first battery-powered home smoke detector, he exercised his warrants which gave us another \$85,000, even though their original loan had been extended two years beyond its five year term.

In that period, we were able to secure two separate SBA loans, one under the 503 program in which the venture capital company participated and the other a 7A, guaranteed loan through our bank for building expansion.

When the company was sold in 1977, the venture capital company owned 35% of the company and reported the largest return on an investment at that time in the history of the National Association of SBICs.

People have often asked me if the venture capital company didn't get more than its pound of flesh. I have always responded that "that" venture capital investment was one of the best things that ever happened to me." The advice and counsel I received over twelve years was the critical factor that allowed our company to succeed.

Today, on the other side of the fence, I believe that venture capital is a "business of building businesses" and not a business of just investing money.

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A venture capitalist should not be perceived as some smart person who knows all the answers and is some sort of financial wizard. What makes them valuable to the average small company is the simple fact that through multiple investments, they see successes and tragedies unfold before them at an accelerated rate. They are sensitive to certain characteristics that identify potential success or potential failure.

A good venture capitalist will spend three to six months doing his diligence before making an investment. Give yourself time. Don't wait until payables get worrisome or you can't meet the payroll before you approach the problem.

SBIR winners of Phase I have averaged about one winner out of ten applications. Your proposal ^{IS ONLY} ~~should be~~ on 25 pages or less.

In applying for venture capital, expect the odds to be about one out of thirty. *A BUSINESS PLAN OF ABOUT 25 PAGES IS NOT UNREASONABLE.*

The profile of a candidate:

- 1) An entrepreneur leading the company. (Expect trouble before success).
- 2) A unique product or service.
- 3) A market size greater than \$100 million.
- 4) A 10:1 return on investment in 5 years.
- 5) A well thought-out business plan that is believable (20 pages).
- 6) A future way out.
- ~~7) A "pure product" company with a reasonable valuation.~~
- ~~8) A demonstrated commitment.~~

Company Valuation - Earn it through performance.

				<u>OWNER</u>	<u>V.C</u>
Example:	AeroQuest	(1) \$150K - 12% - \$1.25 MIL	-	+1MIL	(20%)
		(2) 500K - 12% - \$2MIL	-	+2.4MIL	(40%)
	Guiltech	2 1YR OLD - 500K - 3.8% - 13 MIL	-	12 MIL +	

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Venture companies do not want control; they want out as soon as possible after maturity.

A word about multiple SBIR winners v.s. venture capital.

Often, it is a dream to spin off products to start new companies. However, therein is a trap. If the parent company or laboratory expects to grow from licenses or royalties, it usually will not have a sufficient growth potential to attract venture capital.

If the spin-off company has all the necessary attributes to meet the "success profile" except that ownership control is retained by the parent company, it will not be attractive.

We are not interested in funding research labs nor mini-conglomerates. *LUNCH OUR SPEAKER LYLE ALTMAN YESTERDAY DESCRIBED THE PROFILE OF A CLASSIC SUCCESS - A "PURE" PRODUCT CO.*

When we go into an investment, we expect a way out and that generally falls into two areas. The more common direction is acquisition by a major public company usually with a tax free stock exchange; or the company becomes sufficiently successful that it is a candidate for a first class public offering.

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If you have applied to a venture firm and have been turned down, use it as a learning experience. Try to find out what parts of your proposal didn't measure up. Get advice from them on other sources of capital ^{OR} if they believe venture capital is not the correct route for you.

If you are still convinced your company has the kind of potential that will attract venture capital, restructure your business plan or perhaps, even your company. Do a market study, make a new plan and go to another venture capitalist, perhaps one of a different size or one more oriented to your technology.

For instance, our ^{FIRM IS} ~~partners~~ committed to invest in "technology based" companies, most of which will be focused in the four corners states. There are many exciting companies, however, that do not fit our profile but would be of great interest to other venture funds. The SBIR program should be a boon to venture capital, particularly those Phase II winners. We are now in the final stage of an investment in such a company coincident with the Phase II ^{NIH} grant. We ^{ALSO} see possible opportunities with Phase I winners or even losers.

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The most interesting conversation to be overheard in a convention of venture capitalists is to hear them talking about those successful companies that they turned down, ~~or did not invest in.~~ Like, "who would ever have believed people would squirt water between their teeth" or, "a home computer with a dumb name like Apple?"

On the other hand, it is difficult to name a successful high tech company on the front range of Colorado that does not have its beginnings in venture capital. Right now, ^{HOWEVER,} it would be ~~very~~ difficult to get us to look seriously at a micro computer or software of any kind. And because of that, we may miss a big winner. You may just be the one that has that next Apple, ^{PERHAPS} a unique medical device, or a biological process with the potential to save lives or restore health. Therein lies a reward far more valuable than money. And I hope you do just that.

Thank you.