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So you want to raise venture capital: Here's what it really means for your business

Brad Cherniak | August 7, 2015 3:37 PM ET

Fotolia *Does your business have what it takes to attract and keep the interest of a venture capitalist?*

The majority of business owners have only the vaguest notion of what it means to raise venture capital, yet it is one of the frequently heard goals by those who advise small to mid-sized businesses.

But they don't know a lot about it for good reason. Venture capital is not well-defined for business owners.

So that's where I'll start — with a primer on venture capital.

There are a multitude of groups that call themselves venture capital funds, or VCs, that have no obvious commonality. They invest in wildly disparate industries, types and stages of companies, as well as sizes and types of investments.

Others don't focus on investing capital per se, but also offer guidance and other value-add services and mentoring. Some even offer physical space and/or other resources to share with like companies.

Many avoid calling themselves VCs, but seem to do the same things. They refer to themselves variously as super-angels, social capitalists, incubators, accelerators, merchant banks, and so on.

Call them whatever you like, the important thing is what they have in common: It really can't be simpler, they are all looking for aggressive growth.

But in what, you ask. It could be anything — revenues, customers, members, viewers, participants, profits, cash flow, whatever the investees can convince the VC is valuable to compile.

If you can show you can provide this aggressive growth, you can probably obtain venture capital. You may be as traditional a business as it gets, but as long as you have that hook that will deliver aggressive growth you may be attractive to a VC.

I keep calling it aggressive growth, because the VC business model is aggressive by nature. This is the critical essence of venture capital for business owners.

You've probably heard the adage that VCs have two home runs per 10 investments, a couple of break-evens, and the rest are write-offs. That's not far from the truth. It is really the inescapable nature of small to medium-sized businesses.

What this suggests for the business owner is that you should be highly confident in your ability to deliver on the aggressive growth if you want to be one of the home runs, because you are betting your farm on it.

VCs are intimately aware of the two-in-10 paradigm, and thus will do all in their power to identify and nurture their two. It can mean the difference between a long, successful career as a VC, and no career as such. Of course, that means they generally have little time or energy for the remaining eight investments.

There will be a couple that may get middling attention and effort — whatever's left over after tending to the Top 2. The rest are in danger of being orphaned.

Some companies will find the VC's attention, and capital, shut off, forcing them to find new sources of capital. Other companies will pivot to find new business models that consume as little of their remaining capital as possible, or regain the passion of their VC. And some will simply vaporize.

What makes the difference between being in the Top 2 or the other eight, sometimes can be a temporary hiccup. The dividing line is not necessarily obvious. You may even be doing well, just not well enough for your particular VC. Due to other factors at play in their portfolio, you can be dumped into the eight, though not necessarily deserving it.

What it comes down to is the math. From the perspective of a VC, if all your returns come from effectively 20 per cent of your capital invested (the two), then that 20 per cent better provide blow-your-doors-off returns.

As an example, for a VC fund to provide their investors an effective annual 18 per cent return over five years (assuming two home-runs, three break-evens and five write-offs), the two home-runs need to be 10-baggers. Yes, returning $10 for every dollar invested.

If you hope to get the attention of a particular VC, the question you need to ask yourself is, am I confident my company will be even close to a 10-bagger in roughly five to seven years?

That's the real barometer. If you don't measure up, the risk-reward of venture capital may not be for you as the business owner.

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