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How to make venture capital funding work for you

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By the SMU Social Media Team & Ang Ser Keng, Senior Lecturer of Finance, SMU Lee Kong Chian School of Business

Shark Tank, an American reality television series centred on aspiring entrepreneurs pitching their business ideas to potential investors, has become a global phenomenon. It has motivated startups from around the world to have a go at securing a deal in the tank. Aside from being pretty cool and entertaining, the show also aims to teach business owners when and how to look and pitch for investments.

To understand when to turn to Venture Capitalists (VCs) or venture capital firms and how it will work for the business, business owners need to first understand what VCs bring along with their investments and the stage at which they invest in a company.

While Grab and Uber became infamous for making headlines around the world with their astronomical burn rate (the rate at which a company spends its venture capital), VCs did not stop putting money into these companies. Companies like Grab, Uber and even Google have taken on heavy VC funding at the start and this is attributed to the growth potential they have shown as emerging companies.

As a form of financing provided by firms, VCs can either add enormous value to the company at an early stage or dilute your control over your own company. In a recent interview with Dr Ang Ser Keng, who teaches an MBA course in Entrepreneurial Finance at the SMU Lee Kong Chian School of Business and conducts a professional course at SMU Academy, "Venture Capital Financing for Startups", he sheds light on the workings behind VC funding and how to manage and maximise funding for a company's long-term growth.

Why venture capital?

Compared to angel investors who usually invest their personal finances in a startup, VC firms comprise of a group of professional investors with capital coming from individuals, corporations and pension funds. Such firms are responsible for managing the fund and ensuring the company is developing and growing healthily and steadily.

Therefore, Dr Ang emphasises that the key lies in "focusing on the value-add of the external investor, rather than how much the investor is willing to pay for a certain portion of the firm's equity".

"An external investor that can help to grow the business significantly, can help to grow the pie much larger than the founder can do on his or her own. This will enable the founder to own a smaller slice of a much bigger pie. One of the most important contributions of a VC with a strong brand is the credibility that the investment brings to the businesses, as it signals to bankers, suppliers and customers that the firm is in a solid shape."

The cons of VC funding

With every funding comes challenges as you work with external partners and each business decision must be made carefully in consideration of all parties involved. Two of the main concerns for business owners taking on VC funding are unnecessary dilution and reduced control over their company.

The earlier you sell off your equity, the more it will cost you in the long run, especially if your company requires multiple rounds of funding. To protect your company, try to negotiate for dilution terms most beneficial to you or focus on raising only as much as you need to get to the next round. Doing these will prevent unnecessary dilution and allow you to get the highest possible value each round.

Giving up a portion of your equity also means losing the same portion of control over the direction of your business, and you will find yourself giving up more equity over each round of funding. This might not be a bad thing if the VCs share the same vision, but VCs are typically not silent partners, and therein lies another set of issues.

So when is the right time?

Although the "right" time is subjective and differs with every company depending on the growth, stage and nature of their business, Dr Ang points out that there are a few things business owners need to look out for before considering bringing VCs onboard.

"Business owners have to focus on finding VCs who can make a significant positive impact in the growth and development of the business. In addition, while founders need to be prepared to lose freedom to do whatever they wish, they have to remember that investors are buying into a firm that comes with the brilliance of the founders and management team in terms of their knowledge of the business, market and customers."

"Know when to walk away from the deal because only when (founders) are willing and able to walk away, they will be assured of a good deal,"

"Lastly, be crystal clear about the durable competitive advantage(s) of their business, and how these advantages can be sustained or ring-fenced against competition. This attracts VCs and gives them leverage to work on maximising on that competitive advantage."

At the end of the day, founders need to engage in thorough preparations before taking on a VC or negotiating a deal with one. This includes ensuring that their company is ready—that founders themselves are prepared to lose a portion of control, and for potential clashes in future decision-making with their investors.

"The most important part is for founders to be clear on the specific terms that they must attain and those they can concede. Know when to walk away from the deal because only when they are willing and able to walk away, they will be assured of a good deal," Dr Ang concludes.