

Perpetual fundraising: A “bridge” too far...



The Venture Viewpoint
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This is the third article in a series addressing how local start-ups can overcome the hurdles to building a successful, globally-competitive technology company from the Ottawa/Canada base. The first article outlined five systemic issues: the Canadian discount, perpetual fundraising, slow market adoption, poor sales momentum, and thin ecosystem.

Regarding the funding of local start-ups, the first, “A” round of capital is usually completed by Canadian VC’s because U.S. investors are reluctant to be the first to invest in a nascent Canadian firm. Companies rarely raise enough on that first round to get to the proof points required by the next financing. Invariably, this leads to a “bridge,” usually by current investors, which provides the capital to achieve the remaining milestones.

A company often gets “bridged” a few times before the next major round of financing. Unlike the U.S., “bridges” are a way of life for Canadian companies because of the severe lack of indigenous capital. They occur at almost all financing stages.

This is a big issue because “bridges” have immediate and long-lasting impacts for companies. Building a business often calls for three or four financing rounds over an arduous five-to-six-year period. It takes 12-18 months to move from one externally-verifiable value point to another, for example from concept to the first prototype. VC’s need to measure these value points at each stage of company building. Setting bridges between the 12-18 month “regular” rounds, makes fundraising a full-time proposition.

“Bridges” - a perpetual fundraising treadmill with deleterious effects:

- can distract management from building the business - leading to lack of focus on moving to the next value point
- can make the board and inside VC’s nervous that something is wrong with the business, the market, the team - leading to increased scrutiny and lots of “executive” help, which further burdens management
- can make company appear stressed to the outside world – customers worry about stability and liquidity, external VC’s worry about everything - leading to sales issues and stressed fundraising, respectively

Let’s look at the issues at hand for local venture-backed companies, and some of the strategies used by successful start-ups.

The first issue is not raising enough capital to execute the plan for which that money was initially earmarked.

Despite a 20-30% capital shortfall, most teams start off sticking to their plan “of record,” determined to still deliver enough for the next financing round with the capital on hand. Often, that well-crafted plan is consciously set aside and the team “goes for it” - behaviour often encouraged by the board and VC’s who have great faith in the team’s creativity to do a lot with very little.

I have personally succumbed to this thinking and now believe it is flawed. The expectation of meeting a highly aggressive initial plan - with a 20-30% capital shortfall is sheer folly. Despite an altered return profile, I believe that a new plan needs to be created that recognizes the funding reality, considers market requirements, and delivers milestone hurdles for a proper next round of financing. It is hard to “stop the presses” and adjust, but this distinguishes the more successful companies.

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The second issue relates to companies missing key milestones required by follow-on investors.

This differs from the previous issue in that even with a well-funded start, milestones can get missed. In general, I find that teams plan towards creating a successful product and business, but forget about building the financing process into the day-to-day plan. They don't plan *backwards* from the specific requirements for a particular round, despite the fact that each stage's requirements are fairly well known in the industry.

Take the "B" stage of financing for example. This is when VC's are looking for a significant amount of customer traction. They invariably use the customer as the measuring stick, and "significant traction" usually means customer-driven product trials across a representative set of at least five key customers.

Startups which have successfully raised a "B" round without running into a "bridge" have developed deep customer intimacy, resulting in a wealth of knowledge and credibility that helps to balance their deliverables and the VCs' requirements. Even if they lack some "B" criteria, strong customer support helps in the funding due diligence process. They also mercilessly adjust their plan, cutting out activities that don't add to getting "B" ready." This has

other consequences, but most are easier to deal with than the perpetual fundraising grind.

The third issue is markets moving out, despite good delivery and great customer traction.

For example, if the technology is new and disruptive, or its value proposition is not well understood, adoption may be slow, but the long term business may still be sound; in this case a "bridge" may be a good device. Companies have addressed this in many ways, including bridges, debt financings and early IPO's. As well, many companies have introduced products based on the core technology in alternate markets.

The fourth issue is failure to adjust and take action on the part of management and boards.

This is the hardest one to cure because startups are run by people who take risks and innovate. Founders, management and VC's are in it together. They *have* to be optimistic go-getters to deliver the returns required of a capital intensive business. So when things go wrong, most people involved believe that it will go right - if people work hard enough and smart enough. But sometimes that's *not* enough.

This is when a board must earn its keep. Good boards actively engage the company to help it through the rough spots. Often tough decisions need to be made on issues

usually avoided by management teams such as: the chemistry, capability or delivery shortcomings of the management team itself. At this juncture, the board must act in the best interest of all shareholders - and lead the necessary adjustments.

Finally, perpetual fundraising is a surmountable issue requiring on-going management attention.

We have looked at its effects and major causes, as well as solutions employed by successful start-ups. Taking careful action can circumvent most of the ill effects, which sap energy from the management team and take management's eye off the ball of building value in the business.

It is part of the CEO's job to build and maintain key relationships in the capital marketplace, talk progress, educate all takers on the business and generally prepare key VC's so they are receptive to the company's formal call for capital. This ground work helps in a myriad of ways, from better understanding VC criteria, to aligning with hot sectors, to getting feedback on plans, customers, etc. The more successful companies have a knack for raising money earlier than absolutely required, enabling them to spend more time building value in the business so that subsequent fundraising goes smoothly - a virtuous circle.

Next column: Slow Technology Adoption

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