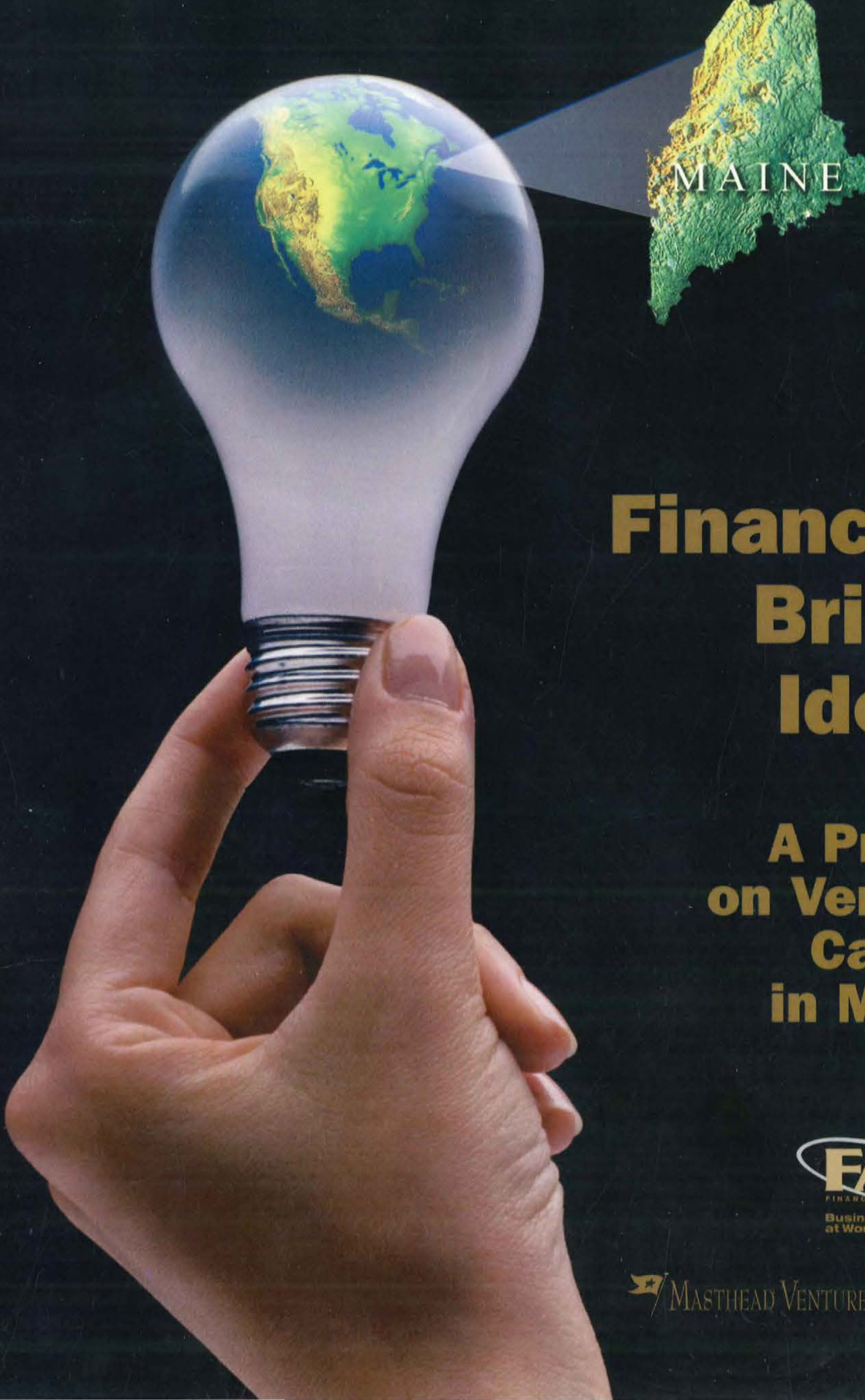

Financing Bright Ideas

A Primer on Venture Capital in Maine

FAME
FINANCE AUTHORITY OF MAINE
Business & Education at Work for Maine

MASTHEAD VENTURE PARTNERS, LLC

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CHAPTER 1

INTRODUCTION

> ***Venture capital** n. Money for investment in innovative enterprises or research in which both the risk of loss and the potential for profit may be considerable.*
>
> *The American Heritage® Dictionary of the English Language, Fourth Edition*

Capital is the lifeblood of businesses. While no amount of money will make a bad business successful, no business can survive without enough money to develop products, hire employees, establish markets and attract customers. For many businesses, particularly in the early stages before profits become predictable, traditional sources of capital such as banks and credit unions are simply unavailable. For those businesses, venture capital may be the best hope to raise the money needed to succeed.

Today, there are more Maine-based venture capital firms than ever before. But while there is no shortage of capital, not every business can get the money it needs or wants. Venture capital is not the answer for all businesses in need of capital. But for those businesses that offer the potential of rapid growth and the potential for considerable profit, informed investors are ready to open their checkbooks.

These high growth businesses not only offer the prospect of substantial returns to owners and investors, they also create new jobs and strengthen the economy. The technology focus of many venture capital stage companies means that the jobs created tend to be relatively high quality jobs. Maine State Government has recognized the importance of supporting these next generation companies and has provided substantial resources to assist entrepreneurs in raising capital.

Maine entrepreneurs want to know whether venture capital is right for them, where to find it, and how to get it. This Primer on Venture Capital in Maine is designed to answer those questions. It explains what venture capital is (and is not), how venture capital investors work, what they are looking for, how to approach them, and what to expect when it comes time to structure an investment. In addition, the self-assessment in Chapter 5 will give entrepreneurs an idea of whether they are ready to seek venture capital. The Glossary of Venture Capital Terms in Appendix A explains many of the terms that are used in the venture capital world. Finally, the Additional Resources List in Appendix B provides some additional sources of capital and more in-depth information.

Venture capital typically comes from four generic sources:

- Private venture capital firms
- Individual investors generally referred to as "angel investors"
- Corporations making strategic investments
- Governmental sources.

Angel investors have been making investments in Maine for many years without any formal tracking of their activity. The first formal venture capital firm in Maine, the Maine Capital Corporation, began operations in 1980. Maine Capital Corporation raised $2,000,000, of which $1,000,000 came from Maine investors with an incentive from the State Legislature in the form of a tax credit. From the groundwork laid by Maine Capital Corporation, successor North Atlantic Capital Corporation has raised two additional funds focused on later-stage businesses. Other funds, profiled in Chapter 7, have also been created to serve businesses in Maine. These formal venture capital funds have not only invested their own capital in Maine businesses, they have attracted out-of-state capital to Maine as well. The result has been a steady increase in the amount of venture capital raised by Maine businesses, although the recession and "dot.com bust" that began in 2001 has at least temporarily halted the upward trend.

While the formal venture capital funds may get the bulk of the attention, angel investors likely fund the most businesses. Angel investors are typically individuals with a business background who invest relatively small amounts of money in small business ventures in or near their communities. They usually make their investments with an expectation of a significant return. But they may also be motivated by a desire to be helpful to a struggling entrepreneur and may provide management, financial, and marketing assistance along with their cash investment. To the frustration of entrepreneurs, angel investors are difficult to find, preferring a degree of anonymity to protect their privacy. Yet angel investment plays a key role in supporting early stage Maine businesses.

Corporate venture capital, or investments by corporations into smaller companies, grew exponentially in the United States during the latter half of the 1990s. This activity has slowed considerably since early 2001. While some corporate venture capital has undoubtedly been invested in Maine businesses, there is no easy way to track or measure it. It does not appear to be a significant source of capital for most Maine entrepreneurs.

Maine Government resources range from the technical advice and business development assistance provided by the Department of Economic and Community Development and Small Business Development Centers, to the competitive grants awarded by the Maine Technology Institute, to venture money for selected companies from the Small Enterprise Growth Fund, to the many financing programs of the Finance Authority of Maine. Every Maine entrepreneur should become familiar with these resources, which are outlined in Chapter 7.

The Finance Authority of Maine (FAME) has published this Primer as a service and resource for the many entrepreneurs in Maine who are collectively striving to build Maine's economic future. This Primer is consistent with FAME's primary goal of providing targeted financing tools, information and solutions that enable Maine citizens to take advantage of opportunities that may be available to them. This is the third major publication relating to venture capital published by FAME, following ***A Study of the Availability and Sources of Venture Capital in Maine*** issued in 1995, and ***Capital Availability for High-Technology Businesses in Maine***, which was issued in 2000.

The Finance Authority of Maine is charged by Maine law with finding ways to help businesses get access to the capital they need to start-up, prosper and create jobs. As part of this effort, FAME has supported entrepreneurs and their efforts through a number of programs and services, ranging from early-stage patient capital programs to loan guarantee and tax-exempt bond programs for established businesses. Programs and services targeted at early-stage businesses include:

- **Maine Seed Capital Tax Credit Program:** This valuable incentive allows entrepreneurs to attract investor capital by offering the investor a credit against Maine income taxes of up to 40% of an eligible investment in a Maine business, and 60% in areas of high unemployment (subject to recently enacted statutory limitations).

- **Small Enterprise Growth Fund:** A State-funded venture capital fund that can invest up to $500,000 in patient capital in promising companies that demonstrate a potential for high growth and public benefit.

- **Maine Economic Development Venture Capital Revolving Investment Program:** This program allows FAME to invest as an equal partner in eligible private venture capital funds that agree to support emerging and early-growth businesses in Maine. It leverages private capital and encourages experienced professional venture capital fund managers to invest in Maine businesses. See Chapter 7 for profiles of participating venture capital firms.

- **Small Business Loan Insurance Programs:** FAME is able to use its loan insurance programs in conjunction with a bank loan to assist small businesses that demonstrate the ability to repay a loan.

- **Economic Recovery Loan Program:** FAME can also provide direct loans, generally subordinate to loans from other sources, to help businesses that have exhausted other sources of financing but demonstrate a reasonable likelihood of being able to repay a loan.

- **Venture capital forums:** FAME has hosted a number of venture capital forums designed to bring entrepreneurs and investors together to share information about venture investing in Maine, and to discuss policy issues and improvements to available programs.

For more information about these and other programs of the Finance Authority of Maine, please go to www.famemaine.com on the Internet or call 1-800-228-3734.

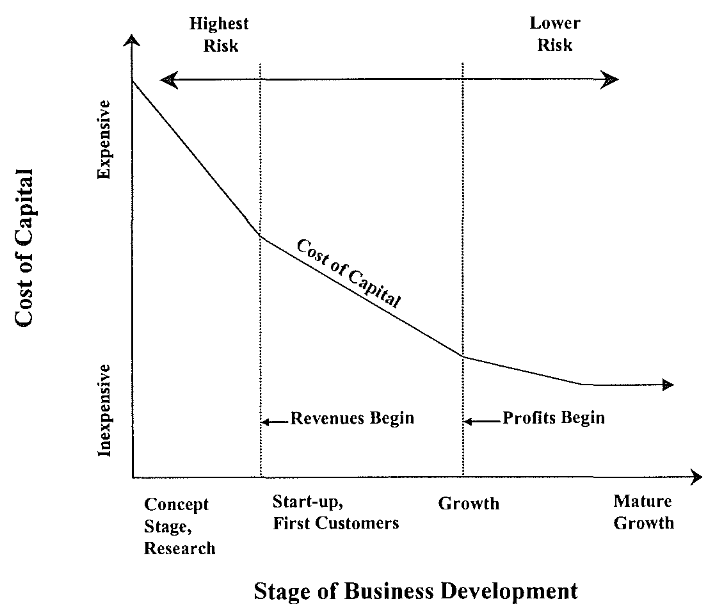
CHAPTER 2

WHAT VENTURE CAPITAL IS (AND IS NOT)

The range of business investment opportunities that interest venture investors is quite broad and hard to precisely define. Simply stated, venture capital is money provided by individual investors or entities seeking a high return on their investment in privately owned business ventures. In order to get those high returns, venture investors are willing to accept a relatively high degree of risk of loss of their investment.

Generally speaking, the financial risk posed by a business venture corresponds with its stage of development, as shown in Figure 1. Certainly there are mature businesses that are struggling and may present a high level of risk, but Figure 1 summarizes the risk spectrum as it applies to most businesses:

Figure 1. Cost of Capital As a Function of Risk



The highest risk level for a business is at its earliest stages (the left side of Figure 1) before it has begun to generate much revenue. As businesses begin to sell products or services, expand, achieve breakeven cash flow and profitability, the level of risk of an investment in that business drops, moving to the right of Figure 1.

As the risk declines, the cost of raising capital for the business declines also, as shown by Figure 1. The cost of raising capital is the price the business must pay to get the capital it needs. It pays that price either in the form of a share of ownership in the business or through payments of interest, dividends, royalties, or other payments. Raising capital also gets easier as the risk level declines, especially once the business progresses to the point that banks become interested in lending it money.

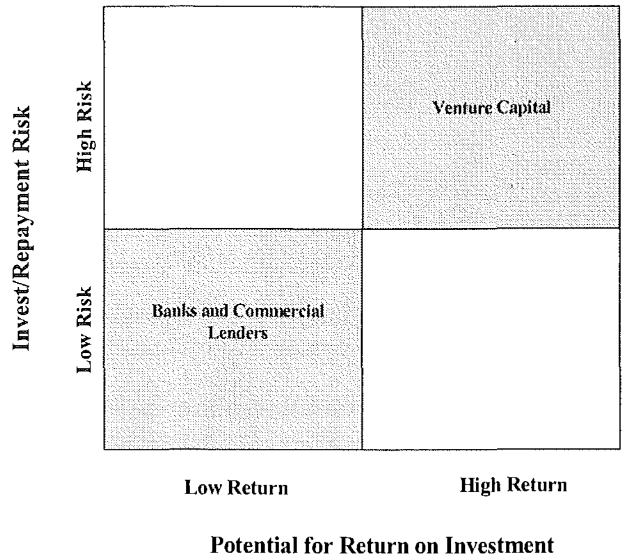
Given a choice, entrepreneurs looking for money for their business will try to raise that capital at the lowest cost possible. Usually, the least cost option for a business is a loan from a bank or other commercial lender. These lenders look for an annual return that is typically in the range of about 5% to 12%, varying with changes in the Prime Rate of interest. Venture investors, on the other hand, look for annualized returns more in the range of 25% and up. So entrepreneurs looking for money will usually look for venture capital only if they do not have the choice of lower cost capital.

Banks and other lenders can offer comparatively low rates because they lend to companies that have a low risk of defaulting on their loans. Companies that present a low risk of default would be placed on the right side of Figure 1. Some entrepreneurs complain that banks will only lend to businesses that do not need the money. The truth is that banks earn a comparatively small profit on the funds they lend; therefore, they cannot afford to make many bad loans. One bad loan may cost a bank more than the profit it makes on 25 good loans. Banks strive to keep their losses on bad loans to significantly less than 1% of their portfolios, so they lend to businesses that demonstrate the ability to repay the loan. Also, banks are looking for current income, and expect payments of interest, and usually principal as well, on a monthly basis.

Venture capital investors, on one hand, are willing to make investments in businesses that are too risky for banks; that is, companies which would be placed toward the left side of Figure 1. Because higher risk means a greater ratio of bad investments to good ones, venture investors expect a much higher return on their successful investments to make up for the losses on their investments in companies that are not successful. Most venture investors do not expect to get regular payments, at least until the company is established and profitable. They look to make their profit down the road when the company is sold or when it issues stock to the public in an Initial Public Offering ("IPO"). Stated another way, venture investors look to participate in the increased value of a successful business venture, while banks and other lenders look to lend money for a fee and expect to receive regular payments regardless of changes in corporate value.

Figure 2 is a simplified way of looking at the respective risk-reward tradeoffs applicable to venture capital investors and bank lenders:

Figure 2. The Risk/Reward Matrix



Note that while venture capital investors invest in a high risk, high return environment (upper right quadrant) and banks lend in a low risk, low return environment (lower left quadrant), there are no capital sources in the high risk, low return quadrant. Venture capital is not the answer for all businesses that are unable to get a bank loan. Venture investors are not interested in taking a high degree of risk for a low return (upper left quadrant) and entrepreneurs are usually not willing to offer a high return on an investment with low risk (lower right quadrant) when they can probably get the money they need from a bank at a lower cost. Businesses in the center of the diagram or in the high risk, low return quadrant can sometimes find funds from friends and family. Or they may seek public sector sources of equity investments, "near equity" loans and loan guarantees provided by state and local governmental and nonprofit entities (see Chapter 7 and Appendix B). However, these sources, while often weighing public benefit in their investment decision process, are still required to make prudent risk/return decisions in order to remain viable over the long term.

The fundamental question each entrepreneur should consider before pursuing venture capital is whether the potential for return to the investors is high enough to attract the investors' attention. For companies that have not yet generated any revenues or are less than a year or two old, most venture investors are not likely to be interested unless they see a potential to make at least five to ten times their investment over a five to seven year period.

Producing that kind of return to investors usually requires two things: the company has to grow rapidly, and it has to successfully execute an "exit" or "liquidity event" to produce the cash the investors are looking for. To raise venture capital, an entrepreneur has to address these two issues and be able to show both the growth potential and the likelihood that the investment can be converted to cash within a reasonable time frame. Most investors are not interested in funding a "lifestyle" company, which to a venture capitalist means a company that can provide a decent living for the entrepreneur and his or her employees, but cannot produce an attractive return to the investor within a reasonable time frame. Figure 3 further describes what venture capitalists can and cannot do when making investments.

There are three main types of "liquidity events" allowing investors to get the value of their investment out of the company. A public offering of stock through an Initial Public Offering ("IPO") is the most visible exit and often the most remunerative. The second and more common exit is a sale or merger of the company, which may well mean that the entrepreneur has to be willing to give up his or her ownership and involvement in the company. A third way to pay off investors is to "redeem" the stock: i.e., buy it back. The money to buy the stock back can come from other investors, from a bank or other lender, or perhaps even from profits.

A business typically seeks venture capital when it is at a stage that requires a significant change in the way it operates to achieve the growth goals of its managers. Whether the change is bringing a new product to market, a substantial ramp-up in sales activities or the acquisition of new machinery and equipment, the choice of pursuing venture capital brings with it some important decisions for the entrepreneur. To help make those decisions, the next chapter outlines how venture investors work, what they are looking for and what they expect in return.

Figure 3: What Venture Capital...

Is:	Is Not:
A source of capital for high risk businesses	Right for "lifestyle" businesses or those without strong potential for growth
A source of "patient" capital	Money without strings or cost
An investment in the business	Money to repay nonbusiness-related debts and expenses
Money to drive business growth and development	An inexhaustible supply of money that will continue indefinitely
A validation of the business by outsiders	Free from restrictions and conditions imposed by the investors
A way to get access to the investors' contacts and resources	A loan that you can prepay at a low cost if things go well
A source of strategic planning, management and recruiting assistance	An end in itself; rather it is just the beginning of the relationship
A way to get help raising funds in the future	A guarantee that the free market will reward the business and investors
Money that does not have to be paid back by the entrepreneur if the business fails	Available unless the investors can see a way to liquidate their investment in 5-7 years.
Investment looking for a "liquidity event" so investors can cash out	Right for entrepreneurs who want to keep ownership and control indefinitely

CHAPTER 3

HOW VENTURE CAPITAL INVESTORS WORK

In order to understand how to approach venture capital investors successfully, it is important for entrepreneurs to understand how they work, what they are looking for, and what is important to them. While there are different types of venture capital investors with different goals, they all share a desire for a good return on their investment. Success in raising money depends first and foremost on how well the entrepreneur makes the case that the business will be successful and produce an attractive return on investment.

As noted in Chapter 1, there are four main categories of venture capital investors: venture capital firms, angel investors, corporate venture capital investors, and governmental investors. This Chapter will focus first on venture capital firms, which make up the traditional venture capital industry, outlining the general principles and business considerations that guide their investment strategies. It will then outline the other three categories of investors and how their goals and approaches may differ.

Venture Capital Firms

Venture capital firms are entities, usually limited partnerships or limited liability companies, that raise funds from high net worth individuals and institutional investors to invest in a portfolio of business ventures with an expectation of a high return on investment. They are managed by experienced venture investors who have the credentials to entice sophisticated institutional and high net worth investors to place large amounts of money under their management. Of the four main categories of venture investors, venture capital firms are the most focused on generating the highest possible return on investment, because that is what their investors are paying them to do.

There are many different types of venture capital firms with different styles, investment targets, and return expectations. Some focus on early stage companies; others target later stage businesses with proven track records. Some seek a balanced portfolio with some early and some later stage investments. Still others specialize in specific industries, such as information technology or energy. Many focus on a limited geographic area, although some larger funds may invest nationally or internationally. And some, like Coastal Ventures and CEI Community Ventures, Inc. in Portland, invest with social goals as well as expectations of return on investment.

Figure 4 shows a breakdown of generic types of venture capital firms and their average returns through the third quarter of 2002:

Figure 4: Average Annualized Rates of Return on Venture Capital Funds by Type of Fund[1]

Fund Type	1 Year	5 Years	10 Years	20 Years
Seed/Early Stage	-28.6%	44.1%	34.2%	20.7%
Balanced	-19.2%	22%	22.1%	14.7%
Later Stage	-16.4%	13.3%	23.7%	16.1%
Buyout	-8.2%	1.4%	8.8%	12.4%
Mezzanine	-1.6%	7.7%	10.9%	11%
Average of All Funds	-12.3%	8.3%	15.1%	14.5%

The venture capital fund types in Figure 4 are listed in declining order of the amount of risk they are typically willing to take. Seed and early stage funds take the most risk, investing in businesses that have not proven

[1] Source: Venture Economics' U.S. Private Equity Performance Index (PEPI) as of September 30, 2002; Thomson Venture Economics and National Venture Capital Association.

themselves in the market. Over time, seed and early stage funds have achieved the highest average annual rate of return. Balanced funds invest in a range from seed to later stage companies to spread risk. Later stage funds target companies that have proven their business plan in the marketplace and are striving for continued expansion. Buyout funds focus on mature companies that are recapitalizing or restructuring, usually leveraging equity investment with bank debt. And mezzanine funds tend to target proven performers that are close to a public stock offering or sale to a larger industry player. Their risk of having one of their investments fail is much lower than for seed and early stage funds, but their return potential is also lower on the investments that are successful.

It is important for entrepreneurs to understand that in order to raise capital from venture capital firms, they will have to offer a reasonable prospect of paying ***much higher returns*** to the investors than these portfolio averages. In fact, seed and early stage venture firms target returns of 50% or more per year on each investment. The reasons for this are grounded in three realities of venture capital firm economics:

- The first reality of venture capital firm economics is that the returns shown in Figure 4 reflect the entire portfolios of the venture capital funds, both the winners and the write-offs. Obviously, no one can predict which investments will be successful. The managers naturally hope and expect that each of their investments will succeed or they would not invest. But given the inevitability that some investments will fail and some will ultimately pay disappointing returns, all venture firms try to structure their investments so that the returns on successful investments are far higher than the averages. That way, the successful investments more than make up for the losers.

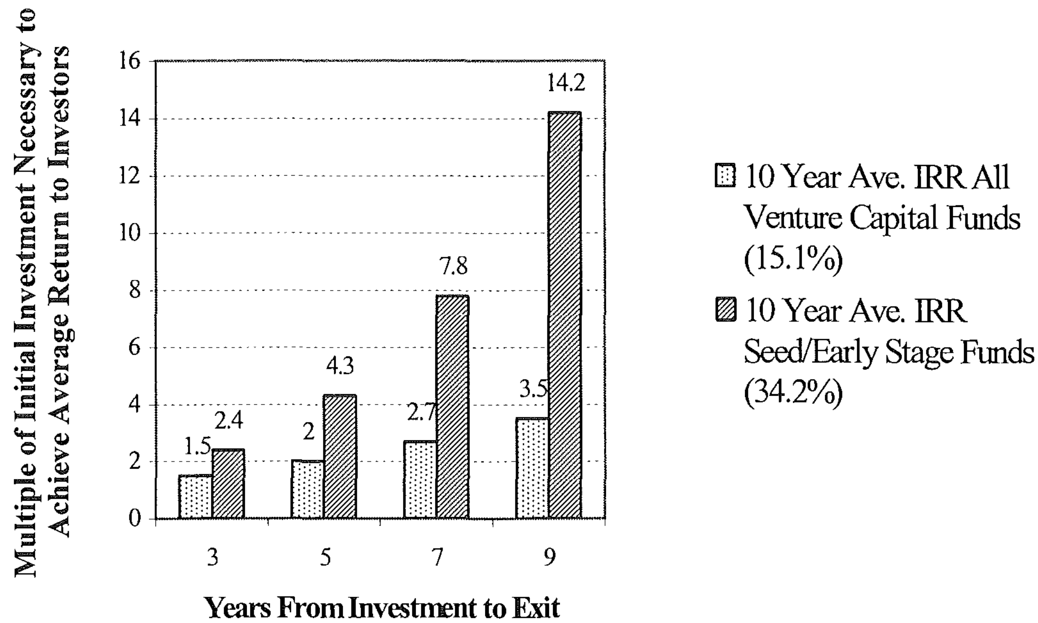
- The second reality of venture firm economics is that the expenses of running each fund are deducted from the fund, and the fund averages shown in Figure 4 are returns ***after*** all payments due to the managers. The managers have to target higher returns on each investment to be able to both get paid for their investment acumen and to beat the industry averages in Figure 4. The typical arrangement between the managers and the investors in a venture capital fund is that the managers get 2.5% of funds under management each year (the "management fee") for the administrative expenses of operating the fund. In addition, as a reward and incentive to the managers, they are entitled to a "carried interest", which is a share of the profits of about 20%.

- The third reality of venture firm economics is that they strive to exceed the industry averages so that they can show future investors a track record that will encourage those investors to invest in the venture firm's next fund. It is harder for venture firms to raise money if their historical returns have been at, or below, industry averages. Investors in venture funds want to see above average, preferably "top quartile" returns: that is, returns that are better than three quarters of all comparable venture capital firms. And, of course, all venture firms want to perform significantly better than publicly traded stocks, since investors will not accept the risks of illiquid, private securities if they do not expect substantially higher returns.

There are two common ways of quantifying returns to investors. The more accurate way is to view the returns as an annualized rate of return over the period between investment and final return. This is referred to as the "Internal Rate of Return", or "IRR", and is expressed as a percentage as in Figure 4. The other view is a simple cash-on-cash return: how much was the ultimate return compared to the amount invested, expressed as a percentage or a multiple. For example, if a fund invests $1,000,000 and receives back $5,000,000, their cash-on-cash return is 500% or "5x".

Figure 5 shows the relationship between the Internal Rate of Return calculation and the cash-on-cash return. For the venture capital investor, it answers the question "What multiple of my investment do I need to get back so that I am at least achieving an average return on my investment?"

Figure 5: Multiple of Initial Investment Needed to Produce Industry Average Return[2]



The bottom axis shows the number of years between the original investment and the return of the investment to the fund, ranging from three to nine years. The bars show the multiple of the original investment needed to achieve just an average net return to the fund as compared to the 10-year averages shown in Figure 4 for all venture capital funds, and for just seed and early stage funds.

For example, if a venture capital fund invests $1,000,000 in a business and the business is sold after seven years, the fund needs to recoup $2,700,000, or 2.7 times its investment on a cash-on-cash return basis, just to hit the 15.1% industry average Internal Rate of Return for all venture capital funds over the last 10 years, including the relatively low risk buyout and mezzanine funds. If that fund were instead a seed and early stage investment fund, its return would need to be $7,800,000, or 7.8 times its investment, to hit the 34.2% average Internal Rate of Return for seed and early stage funds. Naturally, most fund managers hope to get substantially higher returns to balance their portfolios and address the three venture firm economic realities discussed above.

This table also illustrates the importance of time in the venture capital equation. The longer the time between investment and return, the greater the return needs to be to provide the targeted annualized return on investment. That is why venture capital firms push companies hard to grow as quickly as possible to the point where the company can be sold for an attractive return.

So how do venture capital firms select investments to produce the high returns they are looking for? Each firm has its own strategy. However, the following investment principles guide most firms:

1. **Be highly selective.** The reality (a harsh one from the perspective of the entrepreneur) is that venture firms may look at and reject 100 or more investment opportunities for each one they fund. Sometimes they pass over great investment opportunities that are outside that particular firm's area of interest or specialty, or that are potential

[2] Table assumes average returns based on 10-year data in Figure 4, net of 2.5% management fee and 20% carried interest. Derived from a model developed for the National Association of Small Business Investment Companies.

competitors of companies they have already invested in, or that would cause too much portfolio exposure to a particular industry, or simply because the deal is not referred to them by a trusted source. Many are quickly passed over because the Executive Summary does not convey the exciting potential of the business in a compelling way. Others do not meet the firm's exacting selection criteria. Most successful venture firms have a "deal flow pipeline" that brings in hundreds of qualified business plans each year. The managers can afford to be extremely selective about where to invest their time and money.

2. **Seek companies with innovative products and "unfair" advantages in large, ripe markets.** In order to grow at the rate necessary to produce venture capital-type returns, companies generally need to have unique or innovative technologies or services that put them well ahead of the competition, or that can make significant changes in their industries. This generally requires both a technical or product advantage, and a market that is ready to reward that advantage: that is, the customers are anxious for the product. Also, the market has to be big enough to offer the necessary growth potential and attractive exit opportunities.

3. **Back outstanding management teams.** Many venture investors believe that a strong management team will be successful even if the product is mediocre, while a poor management team will not get the job done no matter how good the product is. Some venture firms will only back teams that have shown the ability to manage a business successfully in the same or a similar industry. Other venture investors will help to assemble the right management team around the right product or idea. In either case, venture investors want to back managers who are capable, determined, and persistent, but who are willing to step aside if and when necessary for the good of the company and its investors.

4. **Invest in companies with a clear and realistic exit strategy.** Venture capital firms want to be close and effective partners with their portfolio companies, but only for as short a time as necessary to prepare the company for a profitable exit opportunity. Making an investment is only the beginning for a venture investor: getting the investment back with a maximized return is the end game. That means investors will look for companies that have the potential for a liquidation event such as the sale of the company or issuance of stock to the public through an Initial Public Offering (IPO) within a few years. In some cases, it may be possible for the company to buy the stock back from the investors, usually by borrowing the capital or finding new equity investors. Without an exit, an investment becomes one of the "walking dead" in a venture firm portfolio: too good to shut down, but not good enough to attract a buyer.

5. **Add value to the development of the business and play a significant role in the ongoing management of the company.** Particularly for early stage venture firms, the ideal investment is one where the venture firm has the experience, contacts, and strategic relationships to add significant value to the venture beyond the money invested. Generally, investors like to be actively involved by taking a seat on the Board of Directors and talking to the management team on a regular basis. Entrepreneurs should view venture firms not just as sources of capital, but also as invaluable resources for day-to-day management assistance, strategic planning, assistance in hiring the right management team, contacts with critical suppliers and customers, and help in raising additional capital.

6. **Make sure that companies have access to enough cash to get to cash flow breakeven.** The harsh investment climate of recent years has reminded venture investors of this rule. Many companies have foundered because they were unable to raise more money when their venture capital ran out and the existing venture investors were not willing to continue to fund ongoing losses. Investors pay close attention to the "burn rate", which is the amount by which spending is outpacing revenues each month. When the money runs out, the venture investor either has to put more in, hope the company can raise more, or write off the investment. There is no longer an inexhaustible supply of capital to support struggling companies and bail out prior investors, as there seemed to be during the venture industry "feeding frenzy" that ended in mid-2001.

7. **Build a diverse investment portfolio.** Particularly for seed and early stage investments, seasoned venture investors know that it is very difficult to predict which investments will succeed. When this risk is spread over a portfolio of 10 to 20 investments or more, the overall level of risk to the investors is greatly reduced. In a typical early stage portfolio, of every ten investments, perhaps four will be complete losses and three will become "walking dead": viable but not easy to liquidate. The lion's share of the returns to investors will come from the other three investments, which are the portfolio winners. Many funds also seek to diversify their portfolio so it is not too heavily weighted toward one industry or technology, where the entire portfolio could be dragged down by a single mistake.

Once a venture firm has identified a company that seems promising, it begins what is usually an exhaustive review and analysis process referred to as "due diligence". This review begins with extensive discussions with the members of the management team to assess their understanding of the product and the market, to test the business plan they have assembled, and to evaluate their ability to carry it out.

The prospective investors will then draw upon their own experience and contacts to make independent inquiries about the product or service and the market the company is focusing on. They will perform background checks on the management and talk to customers, suppliers, and competitors. They may employ experts on the technology, the production and distribution capabilities of the company, and the size and growth potential in the market to evaluate the investment proposal and to assess the possibilities for an exit. They will review the legal documents that created the business and that outline the ownership and control process, as well as employment contracts, stock option agreements, and personnel policies. They will closely investigate the company's claims of protection of intellectual property, such as patents, copyrights, trademarks, and determine whether the company owns or has the rights to the assets necessary to its operations.

Successful investors strive to know the business almost as well as the founder or chief executive officer. This intensive due diligence process allows the potential investors to make an informed judgment about whether the risk of the venture is outweighed by the potential for return on investment. The process involves a significant investment of time and money by the venture firm.

At the point in the due diligence process where the venture firm determines that it is seriously interested in making an investment, common practice is to issue a "term sheet" outlining the terms and conditions on which it is willing to make an investment. Please see Chapter 6 for a discussion of the typical terms and conditions contained in term sheets issued by venture capital firms and other sophisticated investors.

Once an investment is made, venture firms tend to be active investors, closely following the progress of the company and looking for ways to help management achieve its objectives. They are likely to ask for a seat on the Board of Directors, and certain to insist on regular financial reporting. Initially, their efforts are focused on helping the business grow. This can include everything from help in filling key management positions to introductions to potential customers, suppliers, and sources of follow-on capital. As the business prospers, venture firms begin to encourage the company to find an exit opportunity that the investor can convert its investment into cash. In this phase, venture investors can be helpful in attracting potential acquirers or developing other exit strategies. Many of the legal terms and conditions imposed by venture investors when they make an investment are designed to push the company toward a profitable exit event (see Chapter 6).

Angel Investors

Angel investors are high net worth individuals who invest in as few as one, or as many as a dozen or so businesses, usually located near their home. They invest with an expectation of an attractive return, using many of the same criteria for weighing investment risk and return potential that a venture firm would use.

Angels are attractive sources of capital for businesses for several reasons. First, they tend to be somewhat more accommodating to entrepreneurs than venture capital firms because they are investing their own money and have greater flexibility in making investment decisions. Second, they are willing to invest smaller amounts of money than venture firms and may be interested in investment prospects that are too small to interest venture capital firms. Third, many angels have valuable experience and contacts from running their own businesses that can be useful to entrepreneurs, and they may have more time to invest than a venture firm does. Finally, angel investors may be interested in making an investment for reasons other than purely financial ones, such as a desire to share their experience with a local business, help out friends, or strengthen their community.

The nature of angel investors makes them particularly appropriate for early stage companies, helping bridge the financing gap until a company is ready to approach venture capital firms. In many cases, this role in bridging the financing gap is reflected in the way the angel investment is structured. For example, rather than developing an elaborate term sheet and arguing about valuation, an angel may invest through a "bridge note" that is designed to convert to equity on the same or similar terms and valuation as the next financing round. In effect, the angel leaves the structuring and valuation decisions to the venture firms who arrive later. If there is never another financing round, the investor hopes to get his or her money back through payments on the note, or the note may convert to stock.

The greatest drawback to angel capital is the difficulty in finding the right angel. Most angel investors do not advertise their investment interest, leaving it up to the entrepreneur to find them. The best way to find an angel investor is through the entrepreneur's existing network of friends, relatives and business contacts. Other options include angel networks like the CommonAngels in Boston or forums like the Maine Investment Exchange or CapitalVenue (see Chapter 7) that bring entrepreneurs and angels together.

Corporate Venture Investors

Corporate venture investors are companies that have their own business operations but that also make venture capital investments in smaller businesses. Like venture capital firms, corporate venture investors invest with the goal of an attractive return, using many of the same investment parameters.

The primary difference between a corporate venture investor and a venture capital firm is that corporate investors usually invest in businesses that offer a strategic benefit to the investor's business or that might be potential acquisition candidates in the future. Strategic benefits might include access to cutting-edge technology, insight into new business opportunities, or the ability to provide input into the development of an attractive product or service that the corporate investor needs.

Finding corporate investors is usually a matter of determining which companies might have a strategic reason to be supportive of the entrepreneur's business. To date, corporate venture capital activity has been limited in Maine.

Governmental Funding

State and federal governments play a significant role in providing financial assistance to growing businesses, often on better terms than can be obtained from private investors. Financial assistance programs target job creation, rural development, research, and other public benefits, and are described further in Chapter 7.

In Maine, the Small Enterprise Growth Fund is a state-funded venture capital fund that currently can invest up to $500,000 in eligible Maine-based businesses. With statutory authority for the Fund vested in an 11-member, Governor-appointed Small Enterprise Growth Board, the Small Enterprise Growth Fund considers investments based on substantially the same criteria as a private venture capital fund. However, investment decisions are also based in part on public benefit criteria, including job creation.

Maine also provides capital for early stage technology-based ventures through the Maine Technology Institute, which provides grants or repayable investments for research and development leading to commercialization. Grants of up to $500,000 are awarded on a competitive basis, with applications reviewed by peer review panels.

The primary applicable program of the Federal Government is the Small Business Innovation Research (SBIR) Program. Administered by the U.S. Small Business Administration (SBA), the SBIR program is a grant program designed to support research and development activities by small businesses. Each year, ten federal agencies accept proposals for research and development in designated fields. Funding is competitive and is based on whether the application meets the qualifications of the agency requests for proposals, technical merit, the degree of innovation involved, and the potential for commercialization.

SBIR grants are up to $100,000 for an initial six month Phase 1 project to investigate feasibility, and up to $750,000 in Phase 2 for expansion of the work done in a successful initial project.

The SBA also administers the Small Business Investment Company (SBIC) Program, which provides investment capital to licensed venture capital companies that meet SBA criteria and observe SBA rules and regulations. Maine funds participating in SBA venture capital programs are outlined in Chapter 7.

CHAPTER 4

HOW TO APPROACH VENTURE INVESTORS

The best way to be successful in approaching venture investors is to offer them a well-constructed investment opportunity that meets their goals and objectives. The easier it is for the investor to see how attractive the opportunity is, the more likely he or she is to invest.

The first step is to develop an executive summary describing the business opportunity in one to two pages, backed up by a business plan that outlines the business, the need for financing, and the opportunity for investors. While there are legendary deals cut over drinks and outlined on a cocktail napkin, the vast majority of investment decisions are made in a more deliberative fashion.

The executive summary is very important because it is often the key to getting an investor to read the business plan. It is a brief summary of the business plan, drafted in such a way that it communicates the excitement of the investment opportunity to the investor and whets his or her appetite to read the business plan. In verbal form, it is often called an "elevator pitch", which is an explanation that is both compelling and brief enough to be delivered in the time it takes an elevator to get from one floor to another.

The business plan should be clear enough that the investor understands it and believes it. The plan should be designed to convey to a prospective investor a fairly complete description of the business and the investment opportunity. It should convince the reader that the author of the business plan has thought through the need for the capital, how it will be used, and what the impact on the business will be. A sloppy, incomplete, or superficial business plan gives a bad impression of the investment opportunity and the entrepreneur.

There are many business plan guides and tools available on the Internet and in the business sections of larger bookstores. While there is no required form, the business plan presented to a venture capitalist should cover certain basic points:

- The mission of the business and the objectives of the management team;
- A description of the product or service, its history, and an explanation of what problem it solves or what is unique or exciting about it;
- Objectives of any ongoing research and development activities;
- The ownership structure and capitalization;
- The amount of investment needed and what it will be used for;
- A description of the market and the competition, and where the company fits into the market;
- Whether the product or service has any proprietary advantage or other protection from competition;
- A description of the industry, its growth trends, prospects, and its major challenges;
- The operations plan with an explanation of challenges, solutions, and strategic relationships;
- The marketing and sales strategy, with the names and size of principal customers;

- The organizational chart, with track records, compensation packages, and resumes of key management and board members, and hiring plans for unfilled positions;

- The historical financial data, along with financial objectives and projections, with assumptions, showing cash flow needs of the business and how they will be met; and

- A discussion of exit opportunities and strategies.

The business plan should be clear in conveying the excitement about the opportunity, but should also be frank in assessing the major challenges and risks. Failing to disclose and address major problems will only call into question the rest of the business plan and the integrity of the author.

Once the executive summary and business plan are put together, the challenge is getting them in front of investors. For privacy reasons, most angel investors do not want to be deluged with business plans from entrepreneurs seeking capital. Entrepreneurs usually find them through a referral from a mutual acquaintance. In some areas, there are angels who band together to review and discuss investment opportunities. These groups, like the Maine Investment Exchange ("MIX") based in Portland or the CommonAngels based in Boston, offer entrepreneurs a relatively quick and easy way to gain the attention of potential angel investors.

Venture firms are relatively easy to find. The venture firms with Maine connections are described in Chapter 7. Venture capital firms in other areas can be easily located through Internet searches. A geographic listing of Small Business Investment Companies licensed by the U.S. Small Business Administration is available at www.sba.gov/gopher/Local-Information/Small-Business-Investment-Companies. A longer list of members of the National Venture Capital Association, with Web site links, is available at www.nvca.com. Appendix B has some additional links to lists of venture firms.

It pays to do some research on venture firms before sending them an executive summary and business plan. Most firms have Web sites that outline the types of investments they are looking for, including geographic location, size, industry, and stage of development. There is no point in sending information to firms that are looking for something different. Most venture firm Web sites also include a list of portfolio companies. Entrepreneurs should prioritize firms that have invested in similar types of businesses, indicating that the firm has an interest in the industry sector and perhaps also some beneficial expertise. However, applicants should be leery of firms that have already invested in direct competitors. Venture firms are unlikely to invest in firms that are in direct competition with a prior investment and do not want to be in the position of having access to confidential information from an applicant that might be of use to that portfolio company.

The entrepreneur should make every effort to set up a meeting with prospective venture firm investors to explain the opportunity and the business plan in person. This is not always easy, since venture firms cannot invest the time to meet with everyone who submits a business plan. Because of the fact that most venture firms see hundreds of investment opportunities each year, companies seeking capital should try to differentiate themselves to get attention.

The best way to get attention and a meeting is to get an introduction to the venture firm from someone that the firm respects, such as a lawyer, an accountant, a scientist, a customer, a company in their investment portfolio, an investor in the fund, or an investor in the company. An introduction combined with a positive recommendation will often get an applicant priority attention. Alternatively, the entrepreneur should try to find a way to meet someone from the venture firm at a venture capital conference or a function designed to introduce investors to prospects, such as the periodic events sponsored by the Maine Investment Exchange or CapitalVenue. If the only available approach is to deliver an executive summary and business plan to the venture firm, it should be followed up with a telephone call and a request for a meeting.

In approaching venture firms, entrepreneurs should remember that these firms typically turn down 99 out of 100 applicants. Because venture firms target so few investments for each portfolio, the fact that they say "no" is not necessarily an adverse reflection on the entrepreneur. Venture firms pass over many potentially worthy investments for reasons unrelated to the merits of the proposal. For example, they may be targeting different technologies or industries, they may already have enough exposure to similar businesses, or they may be between funds and not actively investing.

If the answer is "no," the entrepreneur should try to find out as much as the venture firm will offer about why it was not interested. This information can be valuable in approaching other venture firms. It also may reveal a misunderstanding about the business plan that can be corrected or an obstacle that can be overcome. Entrepreneurs should try to distinguish between a "no" that can be turned into a "yes" and a "no" that is final. If the "no" is final, the entrepreneur can still ask for suggestions of other investors that might be interested in the business. Entrepreneurs should take care not to burn any bridges, but to learn from each "no" and look for ways to improve the business plan.

If the venture firm or angel expresses further interest, the investor usually determines the next steps. In this stage, it is critical that the company be responsive to the questions and concerns of the investor. Even a signed term sheet does not mean that the cash is in hand; the investor can still balk at anything that comes up during the due diligence process.

When the investor makes an investment, the relationship is only beginning. It is important that the company keeps the investor well informed and avoids unhappy surprises. The investor can be a key to the success of the business by providing wise counsel, contacts to important strategic partners, and more money when needed. Most businesses, particularly early stage ones, will have to go back to their investors for more money at some point, so it is important to continue to treat investors as well or better after they invest as they were treated before the investment. And in the long run, an entrepreneur who makes money for an investor has an advocate and supporter for life.

CHAPTER 5

ARE YOU READY FOR VENTURE CAPITAL? A SELF-ASSESSMENT

There is no magic formula for determining when or whether a business is going to get funding from venture capital investors. However, the following table will give you an idea of whether you might be well received by investors and where you need to focus your attention on improving your Business Plan.

Simply give your business an honest assessment on each of the questions and circle the highest applicable score in the column on the right. When you are done, add your scores. The key at the end of the assessment will give you an idea of how prepared you are for venture capital.

PRODUCT OR SERVICE	SCORE
1. How badly does your customer need this product or service?	
A "must-have" that solves an important problem	**3**
A compelling and unique product or service	**2**
The product or service is an improvement over the competition	**1**
Customers might want it but do not necessarily need it	**0**
I don't know whether there are customers for it	**-2**
2. Is there any protection from competitors?	
Patent protection is in hand or in process	**2**
Copyright protection or hard-to-discover trade secret	**1**
By the time competitors wake up, I'll have the top name in the market	**0**
No barriers to competition, or the product is already available in the market	**-2**
STAGE OF DEVELOPMENT	
3. At what stage is your product development?	
The product is available and has been proven in the marketplace	**2**
There is a working prototype and it is ready for production	**1**
The product is developed but needs more work before it can be sold	**0**
We will develop the product as soon as we get venture capital	**-2**
4. How much progress have you made in developing key customers?	
We have strong customers who are advocates for our products	**2**
We have identified key customers and are making good sales progress	**1**
We need to further develop the product before generating sales	**0**
5. Is your venture a business or a project?	
The business is operating, has growing revenues and happy customers	**2**
Everything is in place to launch the business as soon as we get funded	**1**
I need funding to finish product development and testing	**0**

MARKET SIZE AND SHARE	
6. How big is the potential market for your product?	
More than $500,000,000	**2**
$75,000,000 to $500,000,000	**1**
Less than $75,000,000	**0**
7. How fast is the market growing?	
Greater than 20% per year	**2**
10% to 20% per year	**1**
Less than 10%	**0**
8. How big a share of the market can you realistically get in 5 years?	
Greater than 15%	**2**
5% to 15%	**1**
Less than 5%	**0**
MANAGEMENT	
9. How experienced is the Chief Executive Officer?	
Has run similar companies that have had successful exits for investors	**4**
Has built and run a similar company successfully	**3**
Has extensive experience in the industry and is well known	**2**
Knows the product well	**1**
A CEO will be recruited	**0**
I can learn on the job	**-2**
10. Is the founder ready to relinquish control if necessary to make the business achieve its full potential?	
Yes, the business needs to be run by the best possible management team	**2**
Theoretically yes, but I do not plan to let that happen	**0**
No, this is my business and I know best how to make it successful	**-2**
READINESS TO PURSUE VENTURE CAPITAL	
11. Do you have a business plan?	
Yes, it is well researched, very complete, and customers are anxious	**2**
Yes, although I am still filling in some details	**1**
Only a rough outline, but the product is great	**0**
This idea is so good it doesn't need a business plan	**-3**
12. Are you willing to allow investors to be involved in business decisions?	
Yes, they will serve on the Board and play an influential role	**2**
I will put them on an Advisory Board	**1**
No, I really don't think they can help me right now	**0**
13. What percentage of the ownership in your company are you willing to give up?	
I will give up one-third or more for the right investors	**2**
I would rather not give up more than a quarter of my company	**1**
I will give up a small amount of ownership if I have to	**0**

RETURN POTENTIAL	
14. What return on investment can your investors expect?	
Ten times their investment or more	**3**
Six to nine times their investment	**2**
Four to five times their investment	**1**
Less than four times their investment	**0**
15. How long do you realistically think it will be before the investors can receive their return on investment?	
Five years or less	**2**
Five to seven years	**1**
More than seven years	**0**
16. How do you realistically expect the investors to get their return on investment?	
We will be an attractive IPO candidate or candidate for sale to the leaders in our industry	**2**
We will be acquired by a similar company in our industry	**1**
We will pay dividends and the company or I will buy their stock back	**0**
OTHER	
17. I plan to use the money raised to:	
Further develop the business	**0**
Pay my living expenses	**-2**
Pay off debt or other investors	**-3**
18. When this money is spent, I will:	
Be profitable and growing rapidly	**2**
Be at cash flow breakeven and growing, with profits in sight	**1**
Be at cash flow breakeven	**0**
Need to raise more money to keep going	**-3**
Grand Total:	

How Did You Score?

Point total 30 to 38: You have an interesting proposal that should garner the interest of venture investors.

Point total 23 to 29: Your business has possibilities and might be of interest to angel investors, but probably needs more work before you will be able to raise significant venture capital.

Point total 16 to 22: You may be on to something here, but you probably have a way to go to attract investors.

Point total 10 to 15: A long shot. Reread this Primer and go back to the drawing board.

Point total below 10: You should probably not expect to raise venture capital for this venture.

CHAPTER 6

INVESTMENT STRUCTURE AND VALUATION

Congratulations! You have found a venture investor who wants to provide you with the capital you need to move your business to the next level. You have received a term sheet from the investor that outlines the amount of money that will be invested in your company, the percentage of ownership or rights to ownership the investor is expecting, and the significant terms and conditions of the financing. You are ready to agree to it and anxious to get a check. But before you sign the term sheet, you need to make sure you understand what all the fine print means.

Ideally, you should have your attorney review any term sheet, as well any documents that are necessary for the closing of the investment. If you have not already started working with an attorney, this is the time to retain one, or you may regret it and pay a price later. You should select someone who is familiar with venture capital financing, understands accepted practices in the industry, and which provisions in the term sheet and closing documents can and should be negotiated. An inexperience attorney can do your relationship with the investors more harm than good and cost you needless time and money.

The first thing to be aware of is that usually the term sheet will specifically say that it is nonbinding and an expression of intent, not a firm commitment. Because the term sheet is nonbinding, you should not act on the assumption you have money in the bank until the deal is closed and you do, in fact, have money in the bank. Investors can and do change their minds and decide not to make investments for which they have issued term sheets, usually because they learn something while making further investigation that makes the investment less attractive, or possibly because they find out that something you told them is not true. To the extent any provisions are intended to be binding, they are specifically stated in the term sheet. Binding provisions might include an obligation to pay the investor's closing expenses and attorney's fees, even if the investment does not take place, or a requirement that the business not talk to other prospective investors for some designated period of time.

A major issue, and one that tends to be hotly debated between the company and the investor, is the valuation of the company. The valuation is important because it determines the percent of the ownership of the company that the investor is buying. The entrepreneur argues for a higher valuation so his or her percentage of ownership stays as high as possible. The investor argues for a lower valuation in order to maximize its return on investment.

The determination of what the valuation should be is more art than science, particularly for early stage companies that do not have a track record of revenues and earnings. Venture investors are primarily concerned with arriving at a valuation that can provide them with their targeted return on investment. Valuation requires an estimation of the company's potential for growth and its likelihood of achieving that growth. Further, prospective investors will make an assessment of how similar companies are being valued in the market today, and a prediction of how attractive the company will be in the marketplace after three to five years of successful operations. From the perspective of investors, the amount of time, effort and money previously invested in the company is not very relevant to its valuation, nor is the valuation that might have been placed on the company by earlier investors.

One common method of establishing a valuation is to project what the revenues or profits of the company will be in five years and multiply those revenues or profits by the projected ratio of price to revenues or price to earnings that might be applicable to companies in that industry at that time. The result, the valuation at the five-year mark, is then discounted back to the present using a discount rate equal to the hoped-for internal rate of return on the investment (see Chapter 3). To the investor, the resulting number represents the valuation today that will allow them to achieve their desired return on investment at some point in the future. Venture investors are naturally likely to take a more conservative view of future revenues and profits than you do for purposes of determining what your company's value is, to provide some cushion if things do not go as well as you expect. You should not take this as an adverse reflection on your credibility or honesty. Rather, it is a reflection of the investor's experience that businesses do not always progress according to projections.

Ideally, you would like to have several venture capital firms or investors competing to invest in your company. Then you can truly test what valuation the market will bear. The fewer term sheets you have, and the more you need the money, the less negotiating leverage you will have. Also, the advice, experience and connections an investor can bring to the company may be of great value. In the long run, how well the company performs and the price it is ultimately worth in the future is more important than getting the highest possible valuation today. If the venture investor brings needed expertise or connections to potential customers, strategic partners and future sources of capital, that contribution can be more valuable than the investment they are making.

Equity investors talk about valuations either "pre-money" or "post-money", and it is important to understand the difference. "Pre-money" valuation is what the investor is valuing your company at before he or she makes an investment, while "post-money" is the "pre-money" valuation plus the amount of the new investment in the company. For example, if an investor invests $1,000,000 at a pre-money valuation of $3,000,000, the post-money valuation on the date the investment occurs is $4,000,000 and the investor owns, or has the right to own, 25% of the company.[3] If, however, the investor puts in $1,000,000 at a post-money valuation of $3,000,000, the investor will own 33% of the company.

You should be prepared to generate a table outlining the capitalization of your company. Commonly referred to as a "cap table", this is an important tool for both you and your investors to understand the ownership of the company today and on the day after the investment takes place. The new investment results in "dilution" of the ownership of any existing shareholders. For example, if you are the only owner today, you own 100% of the company. If an investor puts in $1,000,000 at a $3,000,000 pre-money valuation, you will own 75% of a company now worth $4,000,000. *Note that the value of your ownership interest has not changed even though you no longer own 100%.*

Investors will want to know what your plans are for issuing stock options, and may place limitations on them because of their potential impact on dilution. Stock options are a right to purchase stock in the company at a designated price at the election of the holder of the option. Options are generally used to provide an incentive to employees or other key people to support the growth of the company. The difference between the "strike price" (the price the option can be exercised at) and the value of the stock on the day the option is exercised can provide a significant financial benefit to the option holder when the stock becomes marketable. Stock options having a strike price less than the value of the stock are referred to as "in the money". On the other hand, when the stock price is less than the option strike price, the options are "under water". Stock options, if any are issued or reserved for issue, need to be factored into the cap table on a fully diluted basis: i.e., assuming they are exercised, so everyone can understand what their fully diluted ownership position is.

The same is true of any warrants issued or to be issued by the company. Like stock options, warrants are rights to purchase stock in the future at a designated "strike price", and exercise of those warrants dilutes the ownership of all existing shareholders. Commonly granted to investors or entities that have loaned money to the company, warrants differ from options in that they are, or may, be separately tradable, whereas options are usually only for the benefit of the initial recipient. Some investors, particularly in later stage companies, may structure their investment as a loan with an "equity kicker" in the form of warrants. Those investors get their return on investment through payments of principal and interest, plus they share in the increased value of the company through the warrants to buy stock in the future should it increase above their strike price.

An important consideration is the extent to which the investor expects to have control of the company. While the investor will in most cases have voting stock equal to its percentage ownership, it is also likely to require one or more positions on the company's board of directors. Since the board of directors control key business decisions, not the least of which is the employment and compensation of key personnel, the composition of the board is important both to the entrepreneurs and the investors. While it is typical for investors to have less than a majority on the board, it is not unusual to have provisions that give the investors the right to appoint additional board members under certain conditions, such as failure to meet agreed benchmarks. Also common are provisions that require supermajorities (two-thirds or three-quarters of the board members, for example) for certain major decisions, such as taking on additional investors or selling the company or its assets.

The term sheet will also outline what form the investor's equity interest will take and what rights will be required. From the entrepreneur's point of view, you would like it if the investor purchases common stock, the same security you probably own. Common stock is the basic unit of equity ownership. Investors, however, usually expect to be

[3] See Appendix A for an explanation of some of the key investment terms.

granted "preferred stock", giving them some priorities and other advantages over common stockholders, and reflecting the fact that they are paying cash for their stock while the majority owners may have gotten their shares in exchange for "sweat equity". Later rounds of investors may additionally expect preference over prior preferred investors. The term sheet outlines what the investor expects its preferred stock will look like.

As the name implies, preferred stock has specified preferences over common stock, the most typical being outlined below:

Dividend Preference

Some preferred stock investments will require that a dividend of some specified percent be accrued on the preferred stock and paid before any dividend can be paid to holders of common stock. Others may not specifically provide for a dividend payment, but almost certainly will require that no dividend be paid to the common holders unless the preferred holders are also paid. In cases where there is more than one "series" of preferred stock, the later investors may demand dividend preference over holders of earlier series.

Liquidation Preference

What if your $4,000,000 post-money company has to be liquidated in a year for $1,000,000? You as the holder of common stock would like to split the proceeds on a pro rata basis with all of your investors, but holders of preferred stock are going to insist that they get paid first. In this example, the preferred holders would get their money back and you and the other common holders would get nothing.

In fact, preferred holders will probably not be happy just to get their money back first in the event of a distress sale of the company. Most will expect all of their accrued but unpaid dividends to be paid as well. It has also become increasingly common for investors to ask for dividends plus a multiple of two or three times their investment. That increases the chances that the investors will achieve a decent return if the company is sold at a distress price, but it also increases the likelihood that the holders of common stock will receive nothing.

Conversion Rights

Preferred stock typically comes with the right to convert to common stock at the option of the holder. For example, if the company is successful and able to go to the public stock markets with an Initial Public Offering ("IPO"), preferred holders will usually convert to common stock right before the IPO. The common stock can then be sold at the price of publicly traded stock, although such sale is often subject to a restriction on sale for a period of time after the IPO. If the company is being sold to another company at a significantly higher price than the post-money valuation at the time the preferred stock was issued, the preferred holders will likely convert and be paid their pro rata share of the profitable sale.

Participating Preferred Stock

Traditionally, preferred stock holders could hold their preferred stock and be paid their investment amount plus any accrued dividends, or they could convert to common stock and share in the bounty of an IPO or favorable sale. Since the bursting of the technology bubble and the decline in private equity investment activity, however, it has become common for preferred holders to get the benefits of both. In the case of "participating preferred stock", the holders are entitled to have their investment repaid along with any accrued dividends and any multiple of their investment they may have negotiated, and then still retain the right to convert to common stock and "participate" along with all other common stockholders in the remaining proceeds of a favorable sale or IPO.

Redemption Rights

Investors usually have the right to require the company to "redeem" or repurchase the investors' shares at or after a designated period of time and at a specified price. While not often exercised, this right provides the investors with another potential exit opportunity. Investors would consider using a redemption provision in the case of a company that was doing well enough to be able to raise the capital to pay the redemption price, but not well enough to attract a buyer at a favorable price. It is also a tool to prod the managers of the company to look for a buyer when they might prefer not to.

Antidilution Protection

Antidilution provisions protect the investors' pro rata ownership of the company in the case of events such as stock splits or the issuance of dividends in the form of stock. In addition, antidilution provisions generally address what happens if the company sells additional stock to investors.

In its simplest form, an antidilution provision will require that if the number of common shares increases due to a stock split or stock dividend, then the number of shares into which the preferred stock can convert must increase accordingly. For example, if the company issues each holder of common stock a new share of stock for each share already owned, the number of shares of common stock doubles and the value of each share is cut in half. In that case, preferred holders want to be able to convert their stock into double the number of common shares to protect their percentage ownership of the company.

More complicated issues arise when the company wants to issue new shares of stock to new investors. The issuance of stock to new investors dilutes the ownership of each existing investor. For example, if you own 60% of the company you founded and you have sold 40% to Investor A, and later you want to sell 25% to Investor B, your percentage ownership and Investor A's percentage ownership (on an as-converted basis) would have to drop since the total ownership cannot exceed 100%. In this example, Investor A would now own 30% (40% of 75%) of the company, while you would own 45% (60% of 75%).

Investor A can avoid this by exercising a "pre-emptive right" to purchase the stock offered to Investor B. Or, if Investor B is paying a price per share higher than Investor A paid, Investor A may be satisfied that even though its percentage ownership has declined, the value of its investment has actually risen. The problem arises when the stock offered to Investor B is at a lower price per share. In that case, Investor A's antidilution protection kicks in. If Investor A has a right to "full ratchet" antidilution protection, and assuming the price to Investor B is half the price per share paid by Investor A, Investor A is entitled to convert into twice as many shares. That right to additional shares comes at the expense of the common stockholders, who are diluted twice: once by the addition of Investor B and then by the increased number of shares that Investor A's investment can be converted into.

This result can be quite draconian if Investor B is only buying a small number of shares for a relatively small amount of money. From the founder's point of view, so-called "weighted average" antidilution protection is much more tolerable. Instead of recalculating Investor A's right to convert at the lower price paid by Investor B, a formula is used to prorate the adjustment based on how much stock is being sold to Investor B, a result that is more favorable to common shareholders than "full ratchet" antidilution.

Registration Rights

In the happy event that the company is successful and becomes attractive to the public equity markets, investors may have registration rights: that is, the right to require the company to register some percentage of the common stock of the company for offering to the public. This is not often exercised, but it is a tool investors can use to push the company toward an exit event.

While many of the terms and conditions outlined above are clearly designed to protect and benefit the investors, most sophisticated investors will not demand overly burdensome preferential provisions because they want the managers of the company to have the financial incentive to make the company as successful as possible. That usually requires an alignment of interest between the management team and the investors: everyone is in the same boat and all oars are pulling in the same direction. If the terms are so onerous that the entrepreneur and management team no longer have the incentive to see the business grow, the terms are self-defeating for the investor. The entrepreneur has every right to negotiate provisions he or she is comfortable with, and the more anxious the investor is to make the investment, the more flexible the terms will be. On the other hand, entrepreneurs need to be careful about sending a message to the prospective investor that their respective interests are not aligned. A rocky courtship does not bode well for a strong marriage.

Chapter 7

SOURCES OF VENTURE CAPITAL IN MAINE

This Chapter will cover the main sources of venture capital available in Maine, along with some other state and federal resources that can be beneficial to businesses seeking to raise capital. The private venture capital funds profiled in this Chapter are only those that are based in Maine or that have been approved by the Finance Authority of Maine under the Maine Economic Development Venture Capital Revolving Investment Program. Other out-of-state venture funds have occasionally invested in Maine businesses, but may not be actively looking for Maine investments. Maine entrepreneurs should start with the private firms and public programs outlined below, but should also explore out-of-state sources through some of the links in Appendix B.

Private Venture Capital Funds—Traditional

The Borealis Fund, L.P.
Jesse F. Devitte, Managing Director
114 N. Main Street, Suite 201
Concord, NH 03301
Phone: (603) 226-4480
Fax: (603) 226-4485
www.borealisventures.com

The Borealis Fund is a new venture capital fund serving New Hampshire and Maine. An affiliate of Village Ventures (www.villageventures.com), the fund targets a range of companies from start-up to growth stage and can invest from about $500,000 to $3,500,000 per company.

Brook Venture Fund II
Andrew D. Clapp, General Partner
50 Federal Street, 5th Floor
Boston, MA 02110
Phone: (617) 451-8989
Fax: (617) 451-2369
www.brookventure.com

Brook Venture Fund II targets expansion stage companies within the following fields: Medical Instrumentation and Software (including biotech), Information Technology (Data, Publishing, Decision Support, Software, and others), Enabling Chemistry and Optical Technologies (i.e., fiber optic, infrared, laser, and others). The company should be generating sales and should be able to achieve sustainable profitability within 18 months under a "base case" scenario. Brook Venture Fund II will invest from $500,000 to $3,000,000.

Masthead Venture Partners, LLC
Braden M. Bohrmann, Managing Member
Four Milk Street
Portland, ME 04101
Phone: (207) 780-0905
Fax: (207) 780-0913
www.mvpartners.com

Masthead Venture Partners seeks investments of $500,000 to $8,000,000 in seed and early stage companies in emerging growth, technology-based sectors of the economy including communications, Internet infrastructure, enterprise applications and the life sciences/medical technology. Masthead targets companies that offer attractive value propositions, "disruptive" or groundbreaking products or applications, outstanding management teams, the potential for significant value creation and timely exit opportunities.

North Atlantic Capital Corporation
David M. Coit, President and Managing Director
2 City Center, 5th Floor
Portland, ME 04101
Phone: (207) 772-4470
Fax: (207) 772-3257
www.northatlanticcapital.com

North Atlantic Capital is currently seeking investment opportunities for North Atlantic Venture Fund III, a $75,000,000 fund closed in 2002. Founded in 1986 as the first institutional equity firm in Maine, North Atlantic has invested in over 50 businesses in a wide range of industries throughout the northeastern United States. North Atlantic will invest $2,000,000 to $5,000,000 in companies that have achieved revenues of at least $3,000,000, and are profitable or within 6-9 months of profitability. In addition to later stage venture financings, North Atlantic invests equity and/or subordinated debt in growth-oriented lower-tech businesses with high margins and strong customer relationships, sponsoring management buyouts and owner recapitalizations. Through active board participation, annual executive education for CEOs, and complimentary strategic advisory services, we help entrepreneurs amplify their competitive advantages and grow their businesses. Our capital and strategic involvement has helped grow many successful Maine companies, including Brunswick Technologies, Diamond Phoenix, IDEXX Laboratories, and Wright Express.

Private Venture Capital Funds—Socially Responsible

CEI Ventures, Inc.
Nathaniel V. Henshaw, President
2 Portland Fish Pier, Suite 201
Portland, ME 04101
Phone: (207) 772-5356
Fax: (207) 772-5503
www.ceimaine.org
nvh@ceimaine.org

CEI Ventures Inc., a for-profit subsidiary of Coastal Enterprises, Inc. (CEI), targets investments of up to $2,000,000 in companies ranging from seed stage to leveraged buyouts and in a wide range of industries. The fund's goals are to make investments that offer above average returns, create economic opportunity for low-income individuals, and fit sustainable development criteria.

CEI Community Ventures, Inc.
Michael H. Gurau, President
2 Portland Fish Pier, Suite 201
Portland, ME 04101
Phone: (207) 772-5356
Fax: (207) 772-5503
www.ceicommunityventures.com
mhg@ceimaine.org

One of only seven New Markets Program Venture Capital Companies approved nationwide by the U.S. Small Business Administration, the CEI Community Ventures Fund targets investments of up to about $500,000 in companies located in designated low-income geographic areas of northern New England. Like CEI Ventures, Inc., CEI Community Ventures, Inc. is a for-profit subsidiary of Coastal Enterprises, Inc. and will target both financial and social returns from its investments: companies should provide employment opportunities for low income individuals and meet sustainable development criteria.

Access to Investors

Maine Investment Exchange ("MIX")
L. Joseph Wischerath
Executive Vice President of Maine & Company
120 Exchange Street
P.O. Box 7462
Portland, ME 04112-7462
Phone: (207) 871-0234
Fax: (207) 775-6716
www.mixforum.org

The Maine Investment Exchange, or MIX, holds periodic breakfast meetings at which prescreened businesses seeking capital make 10 minute presentations on their investment opportunity to qualified investors, both angel and institutional.

CapitalVenue
Holly Fletcher, Managing Partner
P.O. Box 5482
Beverly Farms, MA 01915
Phone: (888) 848-8300
Fax: (617) 249-0402
www.capitalvenue.com

CapitalVenue hosts periodic forums in Maine, Boston, and New Hampshire at which entrepreneurs can sign up for one-on-one meetings with venture funds and other prospective investors for a fee of about $50. In addition, CapitalVenue events include presentations from venture investors and other relevant presenters.

State Government Sources of Venture Capital and Related Programs

Small Enterprise Growth Fund
John F. Burns, CFA, Fund Manager
P.O. Box 619
Augusta, ME 04332-0619
Toll Free: (800) 228-3734
Phone: (207) 623-3263
Fax: (207) 623-0095
www.segfmaine.com

The Maine Legislature established the Small Enterprise Growth Fund in 1997 to help small Maine businesses obtain patient capital. The Fund targets initial investments of up to $400,000 (reserving funds for follow-on rounds) in businesses with the potential for high growth and public benefit, including job creation. The business must be located in Maine and must obtain a co-investment in an amount at least equal to the investment from the Fund. The Fund seeks a reasonable risk-adjusted return on investment within a five to seven year period. Statutory authority for the fund resides with a Board of Directors appointed by the Governor.

Maine Technology Institute
Janet Yancey-Wrona, Ph.D., Director & President
2E Mechanic Street
Gardiner, Maine 04345
Telephone: (207) 582-4790
Fax: (207) 582-4772
www.mainetechnology.org

Established by the Maine Legislature in 1999, the Maine Technology Institute is a nonprofit organization created to encourage and support research and development activity leading to commercialization of new products and services in the State's technology intensive sectors. The primary objective of MTI is to provide seed investment grants to private companies and research laboratories that will increase the level and the pace of research and development and create new jobs for Maine in the following seven targeted technology sectors: aquaculture and marine technology; advanced technologies for forestry and agriculture; biotechnology; composite materials technology; environmental technology; information technology; and precision manufacturing. Grants range from $10,000 early stage seed grants to $500,000 Development Awards, which may require payback under some circumstances. All awards are made through a competitive review process and require a minimum of 1:1 matching funds for project expenses.

Finance Authority of Maine
Charles J. Spies III, Chief Executive Officer
5 Community Drive
P.O. Box 949
Augusta, ME 04332-0949
Toll Free: (800) 228-3734
Phone: (207) 623-3263
Fax: (207) 623-0095
www.famemaine.com

In addition to direct loans and loan guarantees for businesses that can demonstrate a reasonable likelihood of repayment ability, FAME also offers two programs designed to assist Maine companies in raising capital.

The **Maine Seed Capital Tax Credit Program** offers a tax credit of up to 40% of an investment by a Maine taxpayer into an eligible Maine business. The credit is 60% in designated areas of high unemployment (subject to recently enacted statutory limitations). To be eligible, a business must have annual gross sales of less than $3,000,000 and must be either: 1) a manufacturer; 2) a seller of goods or services with 60% of sales derived from outside the State or to out-of-state residents; 3) a business using advanced technologies; or 4) a business that brings significant permanent capital into the State, as determined by FAME.

The tax credit can be a powerful tool to encourage angel investors to make a venture capital investment. The tax credit increases the investor's return on investment. It also protects the investor in the event of a loss, reducing the out-of-pocket cost of the investment by the amount of the credit. The **Maine Economic Development Venture Capital Revolving Investment Program** also encourages private capital to be targeted toward Maine entrepreneurs. The program allows FAME to invest directly in venture funds that are approved as seeking Maine investment opportunities that can create jobs. To date, FAME has invested or committed to invest in CEI Ventures, Inc., CEI Community Ventures, Inc., Brook Venture Fund II, Masthead Venture Partners and Borealis Ventures.

Federal Government Sources of Venture Capital Assistance

U.S. Small Business Administration
Mary E. McAleney, District Director
Edmund S. Muskie Federal Building, Room 512
68 Sewall Street
Augusta, ME 04330
Phone: (207) 622-8274
Fax: (207) 622-8277

Washington Headquarters:
409 3rd St. S.W.
Washington, D.C. 20416
Phone: (800) 827-5722
www.sba.gov

The U.S. Small Business Administration administers a number of programs that can help entrepreneurs raise capital, including direct and guaranteed loan programs. Two programs in particular address the needs of venture capital stage companies.

The **Small Business Investment Company (SBIC)** Program encourages private venture capital firms to invest in small businesses. The SBA provides guarantees that allow licensed Small Business Investment Companies to leverage privately raised capital by as much as three times, effectively making SBA an investor in the fund. In exchange for this capital, Small Business Investment Companies follow detailed SBA regulations on eligibility, structure of investments and repayment of proceeds of investments. The Web page for the program is www.sba.gov/INV.

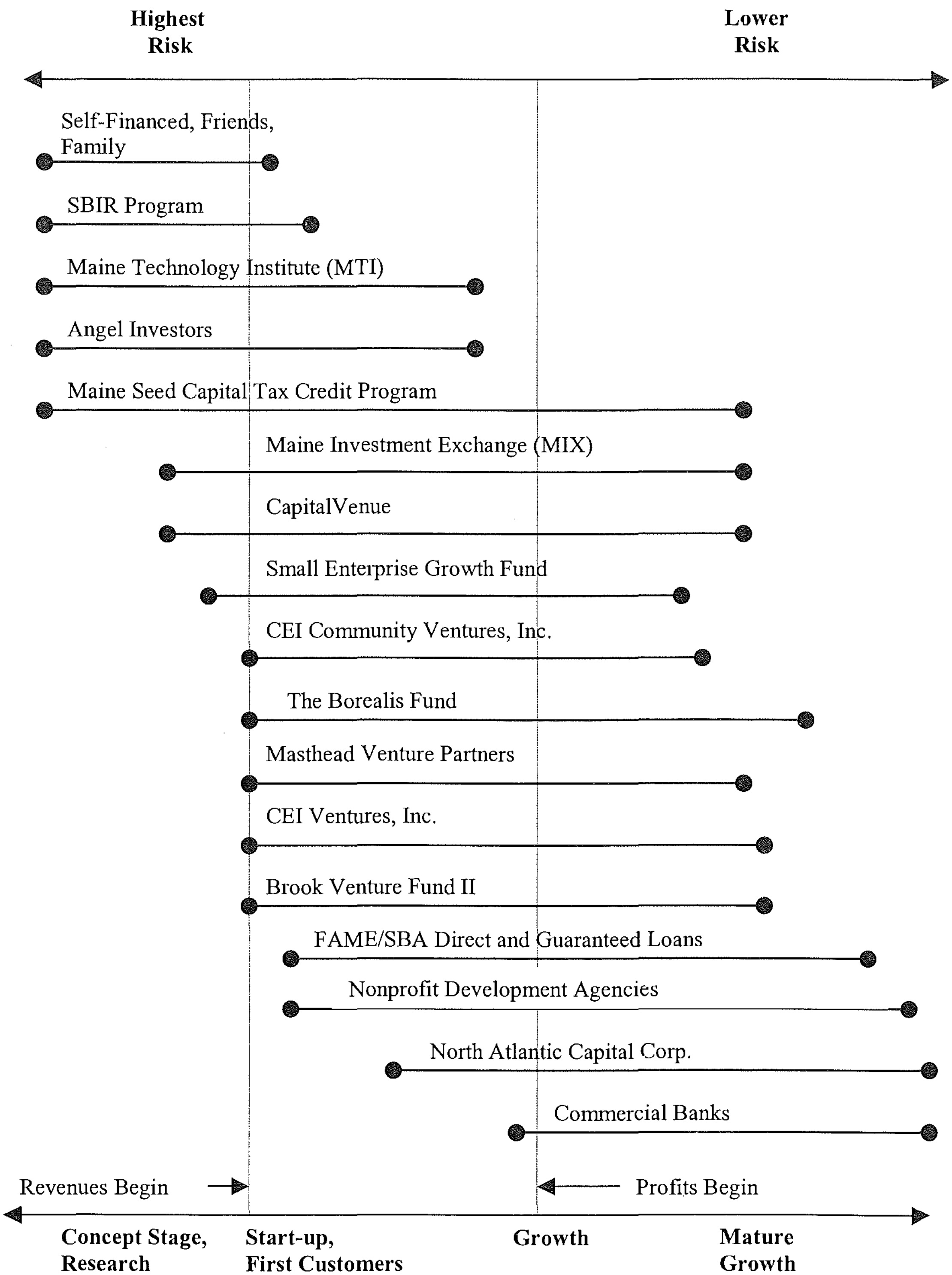
Currently, there are two licensed Small Business Investment Companies located in Maine: North Atlantic Capital and CEI Community Ventures, Inc. In addition, Masthead Venture Partners and Brook Venture Fund II are under review by the SBA and expect licensing in mid-2003.

The **Small Business Innovation Research (SBIR) Program** allows small businesses to compete for federal research and development awards made by ten federal agencies. Phase I is the start-up phase. Awards of up to $100,000 are available in Phase I to support exploration of the technical merit or feasibility of an idea or technology. Phase II awards are available up to $750,000 to be used for research and development to expand on Phase I results and evaluate commercialization potential. Only Phase I award winners can be considered for Phase II. These awards are grants and need not be paid back by the recipient. The application process is competitive, and the criteria include whether the application targets a need of one of the 10 federal agencies and whether the research is commercializable. The related Small Business Technology Transfer Program provides grants of up to $100,000 in Phase I and $500,000 in Phase II for research and development being carried out by a for-profit business in conjunction with a nonprofit institution. The Web page for the SBIR Program is www.sba.gov/SBIR.

Assistance in applying for SBIR grants is available at no charge from the Maine Technology Institute and from the Market Development Center at (207) 942-6389, www.mdcme.org.

Figure 6 shows the approximate relative positions of the private and governmental sources of capital of Maine arrayed on the risk spectrum from early stage/high risk on the left to mature company/lower risk on the right:

Figure 6: Capital Sources on the Risk Spectrum



Stage of Business Development

APPENDIX A

GLOSSARY OF SELECTED VENTURE CAPITAL TERMS

This Glossary contains brief, informal definitions of selected, commonly used terms relating to private equity transactions. Words in **bold** are defined terms.

Accredited investor: An investor meeting defined standards of financial capacity to make a risky, illiquid investment. Generally includes institutions with a net worth of $5,000,000 or more, and individual investors who have a net worth over $1,000,000 ***or*** an annual income of $200,000 or more in each of the last two years, who also expect to earn that amount in the current year. **Securities** regulations limit the number of nonaccredited investors who can invest in a **private equity** transaction.

Angel investor: Usually an individual who is an **accredited investor** who invests with the expectation of a financial return as well as the personal fulfillment of watching or participating in the development of a local business venture.

Antidilution protection: Provisions in typical **preferred stock** purchase agreements that protect the investor from **dilution** in the event of **stock** splits, **stock dividends** or sales of **stock** at a price lower than that the investor paid. See **full ratchet antidilution** and **weighted average antidilution**.

Board of directors: A group of individuals elected by the **stockholders** and responsible for major corporate decisions and actions, but not day-to-day operations. May be called a board of managers in the case of a **limited liability company**.

Bridge financing: An interim financing round that provides cash to a company that is anticipating either a larger financing round, a **merger** or an **initial public offering**.

Blue-sky law: State **securities** laws designed to protect investors, typically requiring **registration** of **securities** offerings.

Buyout: Refers to a financing used to buy a controlling interest in a company from the prior owners. A **buyout** is often accomplished through use of a combination of borrowed capital and **private equity**, in which case it may be called a leveraged buyout (LBO) if the borrowed funds exceed the new capital invested. If the managers of the business are buying it, it is called a management buyout (MBO).

Burn rate: Negative **cash flow** on a monthly basis: i.e., the amount of cash the company is "burning" per month.

Business plan: A description of the plan for a business venture, usually including statements on the product or service, the management team, the production plan, the marketing plan, the competition, the financing needs of the business, and the returns that are projected to be available to investors.

Cash flow: Cash receipts from all sources less cash expenditures over a designated period of time, usually a month or a year. Cash flow positive means receipts exceed expenditures. Cash flow negative means expenditures outpace receipts.

Cash-on-cash return: A measure of a return on investment that does not take the passage of time into account, calculated as the total cash returned from an investment divided by the amount invested and expressed either as a percentage or as a multiple.

C-Corporation: A business registered as a corporation that is taxed as a separate entity under Subchapter C of the Internal Revenue Code.

Class, or series, of securities: Divisions of **securities** into groups with common features, such as voting rights, **liquidation** preferences, etc. A typical **early stage** company might have three classes of **stock**: **common stock**, Series A **Convertible Preferred Stock** that represents the **seed stage round** of **angel investors** and gives them some priority over the **common stock** as well as rights to convert to **common,** and Series B **Convertible Preferred Stock** that represents the first round of capital from a **venture capital** firm and has priority over the other classes.

Common stock: The basic unit of ownership in a corporation, typically having voting rights on election of directors and major corporate actions, and typically being the last to be paid if a company is **liquidated.**

Convertible preferred stock: Stock with priority over the **common stock**, which can be exchanged, or converted, into **common stock** under specified terms and conditions.

Cumulative preferred stock: A **stock** that has a **dividend** that accumulates if not paid by the company and typically must be paid current before any **dividend** is paid on the **common stock**.

Deal flow: Term used by investors to describe the number of prospective companies seeking investment in a given region or over a given period of time.

Debt security: A note, bond or other evidence of an obligation to repay money that has been borrowed, usually with a designated rate of interest and perhaps with collateral, conversion rights, or **equity kickers** such as **warrants**.

Dilution: Typically refers to the impact of an event, such as issuance of new shares, which results in an owner owning less of a company on a percentage basis.

Dividend: A payment to **stockholders** declared by the **board of directors** of a business and usually paid in cash, or sometimes in the form of a **stock dividend**.

Down round: A **venture capital** financing **round** where the **valuation** is lower than it was at the prior **round**.

Due diligence: Refers to the background investigation performed by prospective investors, investment bankers, or their experts and professionals to judge the viability of a business, its product or service, the experience and ability of managers, the truth of representations made in offering proposals, and the terms and provisions of all relevant documents (both internal and financing-related).

Early stage: Generally refers to a business that has passed the **start-up** phase and is beginning to generate revenue. When referring to financing, it usually includes funding **rounds** through and including **first round** financing.

Elevator pitch: A brief, concise verbal summary of a **business plan** that explains why an investment opportunity is compelling, so named because it can be delivered in the time it takes an elevator to get from one floor to another.

Entrepreneur: An individual who creates a business enterprise by assembling the product or service, the business plan for generating revenues, and the team to implement it.

Equity: Ownership in a business entity. Generally, **stockholders' equity** is total assets minus total liabilities.

Equity capital: Money invested in a business in exchange for an ownership interest.

Equity kicker: A right to take an ownership interest in a business at some point in the future, usually evidenced by a **warrant** or **stock option**, or the equivalent.

Equity securities: Stock in a company, typically **common** or **preferred**.

Exit: An event such as a sale of a company, an **initial public offering**, a **merger**, or a **recapitalization** that allows venture investors to sell their investment and realize a return in cash or marketable **securities**.

Expansion round: Investment in a company that is already established and is seeking additional capital for growth. Typically includes rounds from the **second round** to the **mezzanine round**.

Financial statements: The basic documents reflecting the financial status of a business, typically consisting of a balance sheet, an income statement, and a statement of cash flow.

First round: A financing **round** for companies that have passed the **start-up** phase, have developed a marketable product or service, and are ready to ramp-up to begin to generate revenues. Usually follows a **friends and family round**, a **seed stage round**, or both.

Friends and family round: Usually the first source of capital for an **entrepreneur** starting a business is the people close to the **entrepreneur**, who are willing to invest for personal or family reasons.

Full ratchet antidilution: An investor-friendly form of **antidilution** protection whereby if the company sells one or more shares of **stock** at a price lower than that paid by the investor, the investor is entitled to have its number of shares increased so the number of shares times the lower price equals the original number of shares purchased times the original purchase price. See **weighted average antidilution.**

General partner: A person or entity that manages a general or **limited partnership**.

Illiquid securities: Stock or other **securities** that are not readily marketable due to contractual or **securities** regulation limitations, or lack of a market.

Initial public offering (IPO): A company's first offering of **stock** to the public.

Internal rate of return (IRR): A measure of the return on an investment taking into account the time between the investment and the return, and usually expressed as the percentage returned per year. **Internal rate of return** is calculated as the rate of return on an investment that would make the present value at the time of investment equal to all future returns on that investment.

In-the-money: A **warrant** or **stock option** is considered to be "in-the-money" if the "strike price" at which it can be exercised is less than the current market value of the underlying **stock**.

Lifestyle company: A term for a business that operates sufficiently well to support the management team, but not well enough to permit an **exit** that can generate a reasonable return to investors.

Limited liability company (LLC): A statutory structure for a business that offers the limited liability of a corporation along with the flow-through tax structure applicable to a partnership.

Limited partnership (LP): A business entity managed by a **general partner** with most of the rights of ownership concentrated in **limited partners**, whose liability is limited to the amount of their investment. Unlike a corporation, tax liability passes through to the partners.

Liquidation: The conversion of an investment to cash, either through sale of stock, merger with a public company, or sale of assets.

Liquidation preference: A contractual right to a priority return on investment in the event of the liquidation of a business.

Merger: A combination of two business entities, typically structured as a purchase by one company of another or as a tax-free "pooling of interests."

Mezzanine investment: An investment made later in the growth cycle of a company, usually after the initial **venture capital rounds** and in anticipation of, an **initial public offering** or **merger**. It is sometimes considered to be within the broad definition of **venture capital.**

Nondisclosure agreement (NDA): An agreement by which an investor or other person agrees not to further disclose any confidential information they may learn about a company (sometimes also referred to as a Confidentiality Agreement).

Paid-in capital: Money received from investors in exchange for an ownership interest in a business.

Patient capital: Money invested in businesses by investors who are willing to wait for a return on their investment, as contrasted with commercial loans that require monthly payments of principal and interest.

Participating preferred stock: A form of **preferred stock** in which the investor receives both the right to a priority return and the right to a pro rata share with the **common stock** in profits or sale proceeds.

Post-money valuation: The value of a company just after an investment is made, including the new money invested in the company.

Preemptive right: A right given to **stockholders** that allows them to purchase all or a portion of a new issue of **securities** prior to their sale to other investors.

Preferred stock: Stock with terms specifying priority treatment over **common** and other **classes** of **stock**. Typical preference features include a priority on **liquidation** of the company and priority in payment of **dividends**.

Pre-money valuation: The value of a company just prior to an investment of venture capital.

Private equity: Money invested by sophisticated, institutional, or accredited investors prior to an offering of **securities** to the general public through an **initial public offering**. Includes **venture capital**, as well as later-stage private investment, such as **buyout**, **recapitalization**, and **mezzanine** investment.

Private placement: Sale of **securities** that are exempt from the **registration** requirements of federal and state **securities** laws, or are otherwise allowed to be sold to limited numbers of investors under specified circumstances and not to the public.

Private placement memorandum: A written document describing an upcoming issue of **securities** and outlining the terms and conditions of sale and the risks associated with the business venture. Also called an offering memorandum.

Pro-forma: Projected financial statements for a business based on a set of assumptions about the performance of that business.

Prospectus: The principal disclosure document of a public sale of **securities**.

Public offering: Sale of new **securities** to the public, subject to regulatory requirements.

Put option: A right given to an investor to require that his or her shares of **stock** be purchased by the person or entity that issued the option, usually at a set price or at a price set by a formula relating to financial performance.

Recapitalization: A restructuring of a company's capital structure, usually through replacing debt with equity.

Redeemable securities: Stock or other **securities** with provisions allowing the holder to require the company to redeem or repurchase the **stock** at a price favorable to the investor.

Registration: The process by which a privately held company notifies the **Securities and Exchange Commission** and/or state securities regulators that it intends to sell shares to the public.

Regulation D: A regulation promulgated by the **Securities and Exchange Commission** allowing a "safe harbor" exemption from **registration** for certain offerings of **securities**, including an offering to not more than 35 non-accredited investors.

Roll-up: An investment strategy in which a number of small businesses in a fragmented industry are acquired in an effort to consolidate market share and reduce costs.

Round: Investment in an **early stage** business usually comes in "**rounds**", or pools of capital invested at about the same time. A typical sequence of rounds might be: **friends and family round**, **seed stage round**, **first round**, **second round**, **expansion round**, and **mezzanine round**.

Royalty: A payment for the right to use an asset, such as a patent, usually based on a percentage of revenues or profits from sales attributable to the asset.

Rule 144: A rule promulgated by the **Securities and Exchange Commission** permitting sales of unregistered **securities** under certain circumstances.

Run rate: Measure of the annualized rate of revenues derived by taking the revenues for the most recent quarter (or month) and multiplying by 4 (or 12).

S-Corporation: A corporation that has elected under provisions of the Internal Revenue Code to be taxed similarly to a partnership, with profits and losses distributed to shareholders and taxed at the shareholder level.

Securities and Exchange Commission: Federal agency charged with administering and enforcing federal laws pertaining to the issuance and sale of **securities**, including ownership interests in business entities.

Security: In the venture capital context, a **security** is a share of **stock**, a note or bond, or any other document or right that evidences an ownership interest in an enterprise. In a lending context, **security** is collateral or a guarantee offered by a debtor to provide the lender with comfort that a loan will be repaid from some source.

Seed capital: Money invested in the earliest stages of a business, typically used for research and proof-of-concept of a product or service, as well as for assembling a **business plan** needed to seek later financing rounds.

Seed stage: The earliest stages of a new business, in which the entrepreneur develops and proves a concept for a product or service and determines whether it might support a successful business.

Small Business Investment Company (SBIC): A **venture capital** firm licensed by the U.S. Small Business Administration, typically receiving up to two-thirds of its capital from the SBA and subject to regulation under the SBIC Program.

Start-up: A business that is at, or close to, its beginning.

Stock: A certificate or other instrument evidencing an ownership interest in a corporation.

Stock dividend: A **dividend** paid in **stock** rather than cash.

Stockholder: An individual or entity that owns **stock** in a corporation. Also called a shareholder.

Stock Option: A right to purchase (call) one or more shares of **stock** at a designated price (the "strike price" or "exercise price"), often given to investors, employees, or others as an incentive to support the company. Options may be qualified for favorable tax treatment within certain limitations (incentive **stock** options or "ISOs") or non-qualified (NSOs), which are less advantageous from a tax point of view, but much easier to set up and administer.

Sweat equity: Value in a business derived from hard work and know-how rather than from injection of capital.

Term sheet: A letter or memorandum outlining the basic terms and conditions under which an investor intends to make an investment in a business, typically subject to **due diligence**.

Treasury Stock: **Stock** that has been issued and reacquired by a corporation but is not outstanding.

Undercapitalized: A business is said to be **undercapitalized** if it does not have enough money available to it to maintain continuing operations for the foreseeable future.

Underwriter: A **securities** firm that agrees to purchase an issue of **securities** for resale to investors.

Valuation: The value of a business, typically as determined by negotiation between a prospective investor and the **entrepreneur**.

Venture capital: Broadly defined, the term refers to money invested by private investors (other than the **entrepreneur** or primary owner) to finance the **early** and growth stages of a business enteıprise up through **initial public offering** or sale of the business. The investors risk the capital they invest and seek to profit by an increase in the value of their ownership rights in the company. The term sometimes is defined more narrowly to exclude later stage **private equity** investment such as **buyout**, **recapitalization**, or **mezzanine** investments.

Walking dead: Slang term for companies in a venture portfolio that have neither failed nor met expectations. They may be doing too well to abandon, but **exit** opportunities may be scarce.

Warrant: A right to buy a designated number of shares of **stock** at a fixed price or a price set by formula. **Warrants** are often given in conjunction with the sale of a **security**, usually a debt-oriented one.

Weighted average antidilution: A form of **antidilution** protection in which a preferred investor's stake in a company is adjusted for **stock** issued at a lower price by weighting the adjustment based on the amount of **stock** issued at the lower price. Unlike **full ratchet antidilution**, under which the sale of a single share of **stock** at a lower price allows the preferred investor to convert its entire position at the lower price, **weighted average antidilution** adjusts the conversion price based on a formula that takes into account the amount of **stock** sold at the lower price, thereby reducing the impact on **common stockholders**.

Working capital: Money available to a business for its everyday operating needs, usually calculated as current assets less current liabilities.

APPENDIX B

ADDITIONAL RESOURCES LIST

Selected Maine Business Development Resources:

Finance Authority of Maine - **www.famemaine.com** - (800) 228-3734

Maine Department of Economic and Community Development - **www.mainebusinessworks.com** - **www.econdevmaine.com** - (207) 624-9800

Maine Technology Institute - **www.mainetechnology.org** - (207) 582-4790

Maine Science and Technology Foundation - **www.mainescience.org** - (207) 772-9241

Small Business Development Centers - **www.mainesbdc.org** - (207) 679-7232

Small Enterprise Growth Fund - **www.segfmaine.com** - (800) 228-3734

Maine Manufacturing Extension Partnership - **www.mainemep.org** - (800) 637-4634

University of Maine Research home page - **www.umaine.edu/research**

University of Southern Maine Center for Business and Economic Research - **www.usm.maine.edu/~cber**

Maine Nonprofit Providers of Development Loans and Financial Assistance:

Androscoggin Valley Council of Governments
125 Manley Road
Lewiston, ME 04210
207-783-9186
www.avcog.org

Bangor Airport Civic Development Corp.
73 Harlow Street
Bangor, ME 04401
207-947-4842
www.bgrme.org

Biddeford/Saco Area Development Corp.
110 Main Street, Suite 1202
Saco, ME 04072
207-282-1567
www.bsaedc.org

Caribou Chamber of Commerce & Industry
24 Sweden Street, Suite 101
Caribou, ME 04736
207-493-4233
www.cariboumaine.net

City of Portland
389 Congress Street
Portland, ME 04101
207-874-8683
www.portlandedc.com

City of Presque Isle
12 Second Street
Presque Isle, ME 04769-2459
207-764-2503

Coastal Enterprises, Inc.
P.O. Box 268
Wiscasset, ME 04578-0268
207-882-7552
www.ceimaine.org

Community Concepts, Inc.
Market Square
P.O. Box 278
South Paris, ME 04281
207-743-1520
www.community-concepts.org

Eastern Maine Development Corporation
One Cumberland Place, Suite 300
P.O. Box 2579
Bangor, ME 04402-2579
207-942-6389
www.emdc.org

Greater Portland Council of Governments
233 Oxford Street
Portland, ME 04101
207-774-9891
www.gpcog.org

Katahdin Regional Development Corp.
53 Main Street
East Millinocket, ME 04430-1126
207-746-5338
www.emdc.org

Kennebec Valley Council of Governments
17 Main Street
Fairfield, ME 04937
207-453-4258
www.kvcog.org

Lewiston/Auburn Economic Growth Council
P.O. Box 1188
Lewiston, ME 04243
207-784-0161
www.economicgrowth.org

Limestone Development Corporation
291 Main Street
Limestone, ME 04750
207-325-4025

MidCoast Council for Business Development & Planning
49 Pleasant Street
Brunswick, ME 04011
207-729-0144
www.mcbdp.org

Northern Maine Development Commission
2 Main Street
P.O. Box 779
Caribou, ME 04736
207-498-8736
www.nmdc.org

Penquis Community Action Program
262 Harlow Street
P.O. Box 1162
Bangor, ME 04402-1162
207-973-3500
www.penquiscap.org

River Valley Growth Council
34 River Street
Rumford, ME 04276
207-369-0396

Southern Aroostook Growth Council, Inc.
21 Water Street
Houlton, ME 04730
207-532-7113

Town of Fort Kent
416 West Main Street
Fort Kent, ME 04743
207-834-3507
www.fortkent.org

Town of Lisbon
300 Lisbon Street
Lisbon, ME 04252-0008
207-353-3000
www.lisbonme.org

Town of Lubec
40 School Street
Lubec, ME 04656
207-733-2341

Washington-Hancock Community Agency
P.O. Box 280
Milbridge, ME 04658
207-546-7544
www.whcacap.org

Western Maine Finance
150 Main Street, Suite 2
South Paris, ME 04268
207-743-8830
www.enterprisemaine.com

York County Development Corp.
112 College Drive
Wells, ME 04090

Selected Publications:

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Angel Financing: How to Find and Invest in Private Equity. Gerald Benjamin and Joel Margulis. John Wiley & Sons, 2000

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Financing the New Venture: A Complete Guide to Raising Capital from Venture Capitalists, Investment Bankers, Private Investors, and Other Sources. Mark H. Long. Adams Media Corp., 2000.

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Funding and Financial Execution for Early-Stage Companies. Rod Hoagland. Quicksilver CFO Consulting, 2002.

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Raising Capital. Andrew J. Sherman. Kiplinger Washington Editors, Inc., 2000.

Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions, 2000 Edition. Jack S. Levin. Panel Publishers, 2000.

Term Sheets & Valuations. Alex Wilmerding. Aspatore Books, 2002

Venture Capital Handbook: An Entrepreneur's Guide to Raising Venture Capital Revised. David and Laura Gladstone. Prentice Hall, 2001.

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www.investorwords.com -- online glossary of finance terms

home3.americanexpress.com/smallbusiness/tool/biz_plan/index.asp -- American Express Small Business Network: Creating an Effective Business Plan

www.ventureeconomics.com -- Thomson Venture Economics site for news and research

www.ventureone.com -- venture capital research firm

www.pwcmoneytree.com -- PricewaterhouseCoopers venture capital statistics

web.mit.edu/entforum/www/Business_Plans/bplans.html -- MIT Business Plan Resources

www.sba.gov/starting/indexbusplans.html -- SBA resource for business plans.

www.vfinance.com -- vFinance Web site.

www.nasvf.org -- National Association of Seed and Venture Funds

www.nvca.org -- National Venture Capital Association

www.nasbic.org -- National Association of Small Business Investment Companies

www.sba.gov/INV/liclink.html -- SBA links to licensed SBICs

www.findingmoney.com/vc.html -- list of actively investing venture firms

www.businessfinance.com -- business finance directory

www.hoovers.com/industry/description/0,2205,4225,00.html -- Hoover's online directory of venture firms

NOTES

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