



VENTURE CAPITAL FUNDING

THE ULTIMATE BUSINESS STARTUP GUIDE TO SECURING VENTURE CAPITAL FUNDING & PERFECTING DUE DILIGENCE



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GETTING STARTED

Your Guide to Business Financial Reporting

As a busy entrepreneur, bookkeeping and financial operations are the last things you want to think about. Between the day-to-day responsibilities of being a business owner, managing your finances, funding, and reporting can be overwhelming. This guide helps startup founders create and optimize financial reports to simplify budgeting, forecasting, fundraising, and tax prep.

For organization, accuracy, and most importantly, the sustainable growth of your business, a solid financial strategy is necessary. With the tools laid out in this guide, you can improve your financial reporting to better prepare for due diligence, and gain the confidence necessary to win over investors and secure funding.

Due diligence preparation is one of the most common reasons our clients seek our advice. We specialize in working with startup founders and know the common pitfalls and consequences of poorly prepared pitches. This guide will ensure you put your best financial foot forward and 'wow' your next partner with pristine reporting.



In this guide, you will learn:

- How to seek out and properly prepare for venture capital funding pitches
- How to ensure readiness for due diligence with proper reporting
- What to look for in a venture capital partner before signing

Ready to elevate your business financial reports? Let's dive in!

IS VENTURE CAPITAL FUNDING RIGHT FOR YOU?

Breaking Down the Pros and Cons of VC Funding

PROS +	CONS -
<ul style="list-style-type: none">▪ Raise large amounts of capital quickly▪ Manage risk more effectively▪ Networking and collaboration opportunities▪ Increase public exposure▪ Secure future funding more easily	<ul style="list-style-type: none">▪ Reduced ownership stake▪ Increased effort to find investors▪ Difficulties securing funding▪ High performance expectations▪ Strict Due Diligence requirements

Private equity refers to a collective name used for professional investment firms that invest in companies that are not publicly listed. Venture capital, or VC, is a type of private equity that focuses on providing funding during a business’s early stages.

While private equity is often used when investing in larger, pre-established companies, venture capital is specifically for investing in the growth of young, emerging startups that show long-term potential. The requirements to receive venture capital funding vary, but most venture capital firms want to see that your company has proprietary intellectual property, a large market size, a team with expertise and experience, and a current market valuation that allows for a good ROI.

Before you rush into an investor’s office to discuss venture capital funding, you should know what you may be getting yourself into. Although venture capital funding has been the pivotal cornerstone for sustainable growth for many startups, it is important to understand the benefits and downsides.

+ Pros of Venture Capital Funding

01. Raise the Right Amount of Capital

Small business loans are one of the most common ways startups obtain funding. However, small business loans carry their own share of downsides, with most startups only qualifying for \$5 million or less in financing. However, with venture capital funding, startups can receive funds in the seed stage for as small as 100,000, up to \$25 million or more for more established startups.

02. Manage Risk More Effectively

Entrepreneurs can manage the inherent risks in their startups by obtaining venture capital. Startups can avoid many serious problems if an experienced team oversees their growth and operations. There is a 20% failure rate for startups in their first year but choosing a partner or investor who has experience helping startups succeed can improve the odds of making a good decision.

Before diving straight into a deal, it is important to find and work with the right investor. Since 20% of startups fail within their first year, you want to make sure to work with an investor that has experience helping startups succeed. The right partnership will help your business mitigate and manage risk.

Small business loans require regular, monthly payments, adding undue strain onto many small businesses. With venture capital, startups have more flexibility by freeing up working capital that they can reinvest to improve products, hire additional team members, and expand operations. Additionally, most venture capital funds don't require business founders to pledge some form of personal assets as collateral, further mitigating risk.

03. Networking & Collaboration Opportunities

Entrepreneurs are so focused on their businesses that they often neglect to network with contacts that can alleviate the pressure and help their businesses grow. With venture capital, entrepreneurs gain access to a new network that can help them establish successful partnerships, build their clientele, hire critical employees, and raise future funding.

Venture capital funding opportunities also open the door to connect with other entrepreneurs. You may meet partners in the firm that worked in your field and have run companies in the past.



It is no surprise that many successful startup founders become venture capital firm partners themselves after they exit from their businesses. These individuals offer a wealth of experience in scaling a company, day-to-day problem-solving, long-term planning, and financial performance monitoring.

04. Increase Public Exposure

Entrepreneurs that don't have prior experience building successful companies can benefit from working with a venture capital firm. Public relations and media contacts are usually included as a part of venture capital firms' public relations departments, and they're eager to promote your startup.

Companies can attract potential employees, customers, partners, and other venture capital firms interested in raising funds by increasing publicity.

05. Secure Future Funding More Easily

For venture capital firms to increase their return on investment, they want their portfolio companies to raise additional funding at higher valuations. If and when you need additional funding, they are incentivized to find investors. Many venture capital firms will invest in future funding rounds and often contribute more capital as your business grows.

Cons of Venture Capital Funding

01. Reduced Ownership Stake

Small businesses need to dilute their equity to issue new shares to their investors during a fundraising round. Many startups outgrow the initial funding they receive and need to raise additional funding rounds from their venture capital firms. However, this process results in founders losing percentages of equity in their company over time, as well as potential loss of control and decision-making power. To mitigate this kind of risk, founders should only raise the necessary amount.

02. Increased Effort Required to Find Investors

Finding the right investor partnership can take several months, which takes time away from other business management tasks. By initiating the fundraising process before funds become critical, founders give themselves the wiggle room to effectively manage their business while also raising enough money to keep growing.

03. Difficulties Securing Funding

Securing startup funding is difficult. Consider these facts:

- According to the National Venture Capital Association (NVCA), only about 5,000 venture capital deals were made in the United States in 2020.
- Almost 3,000 of these companies had already received venture capital in the past.
- Venture capitalists receive about 1,000 proposals for every 3 to 4 companies they fund

Financing is scarce, and venture capitalists have the right to be picky when choosing startups to invest in. This competitive landscape highlights the importance of accurate financial reporting and forecasts.

04. High-Performance Expectations

Businesses funded by venture capitalists are expected to grow and increase in value quickly. Investors expect a high return on their investment, which increases the pressure on founders to ensure their business succeeds.

Founders that do not meet investor expectations, underperform, or misuse company funds could lose their business. To avoid this type of contention, founders should frequently communicate with shareholders about their expectations and be willing to accept their board's advice.

05. Due Diligence Requirements

Since venture capital partners invest outside money, they must screen startups thoroughly. This vetting process happens in two stages:

1. The first step is to evaluate the business technology and fundamentals to see if a market demand exists and if the product and/or service can be scaled.
2. Then, venture capital partners conduct a more thorough review of your team's background, your company's financial standing, and any legal positioning.

While due diligence can take several months, the process is well worth the time and effort. By identifying and addressing problems early, startups have a much easier time correcting them. Once due diligence has been properly executed, future funding rounds will seem simpler, as many previous issues will have already been reviewed and corrected.

HOW TO SOURCE VENTURE CAPITAL FUNDING

VC Sourcing, Preparation & More

A lot of decisions need to be made when you're starting a business. Deciding whether to seek venture capital funding is one of many important financial decisions you will make.

Although you may be eager to get your business started and expand it quickly, it is critical to make sure you're getting the best deal.

So, where do you start?

Although investing in a young startup is risky for investors, the payoff can be quite attractive. Providing accurate financial reports can enhance confidence and inspire investors to support your company's future. But before you start winning over investors, you need to find them first. You can tap into several sources in your network to get started.

Easy Ways to Source VC Funding

The right partner makes all the difference when sourcing a VC deal. VC firms come in many shapes and sizes, so you'll need to research and seek one that matches your business model and goals. Follow the four steps below to identify the right partners for your business.



Leverage Your Network

Your professional and personal networks are ideal for finding potential VC partners. Start with past and present business associates, colleagues, and other professional peers you've connected with.

Your own network can help point you in the right direction. You can also connect directly with VCs on social media networks like LinkedIn, as well as connecting with other entrepreneurs who have raised capital.

Attending startup events and other in-person networking gatherings can also lead to unexpected or new ways to garner VC funding.



Research Investors Online

The internet will be one of your best tools for researching and identifying venture capital partners that share your vision.

You can find out which VC firms are the best in your industry by visiting websites like [Crunchbase.com](https://www.crunchbase.com). Once you have identified firms that show promise, be sure to do a deep dive into their website, blog, and any other information that will be helpful for you to determine if they will be a good match.



Read and Review

Once you've compiled a shortlist of potential investors, it is time to further expand on your research by reviewing their portfolio companies and investment criteria. You may also want to reach out to other entrepreneurs to ask for referrals.



Reach Out Directly

In addition to referrals, you can also reach out directly to VC firms. Prepare a solid pitch and explain why you think they would make a good partner and schedule a meeting for further information if they are interested.

HOW TO PREPARE FOR DUE DILIGENCE

Due diligence is a critical part of the VC deal process, and you'll want to make sure that you're prepared. A VC firm will likely ask you for a wide range of information about your company, including financial statements and forecasts, customer lists, and a product roadmap. Your team will also be asked to meet with them to see how you work together.

Make sure you show up prepared for due diligence by following the steps below.

Start with a Term Sheet

Before we look at the 4 ways to ensure readiness for due diligence, it is important to understand what a term sheet is and how this important document guides the due diligence process.

A venture capital term sheet acts as a blueprint for an investment. A term sheet lays out the financial terms of the investment, how much your business will be worth, who controls the investment, and who will profit if the company goes public or sells.

Think of a term sheet like a letter of intent. After it is signed, the process of negotiation between your team and the VC can begin. Final investment agreements follow the terms laid out in the term sheet, so it is crucial to understand your term sheet provisions and their implications.

While term sheets require negotiation and confidentiality, they do not signify a legal promise to invest. Some term sheets may also prevent you from soliciting other investors or firms for a certain period.

Term Sheets are important as they set the terms for the following documents:

- The stock purchase agreement
- Investor rights agreement
- Certificate of incorporation
- Right of First Refusal (ROFR) and co-sales agreement
- Voting agreement



Key elements prioritized in the term sheet include:

Valuation

Valuation is a process that calculates the value of your company. Several methods are used to calculate valuation, including the Berkus Approach, Cost-to-Duplicate Approach, Discounted Cash Flow (DCF) Method, the Risk Factor Summation Model, the Future Valuation approach, and the Market Multiple Approach.

Liquidation Preferences

In case of a liquidation, liquidation preferences determine the payout order. If a company must be liquidated, its preferred investors typically receive their money first before other stockholders or creditors.

Protective Provisions

A protective provision is a clause that allows preferred shareholders to veto or block specific corporate actions. If multiple shareholders disagree over the best course of action for the company, protective provisions can help protect the interests of minority shareholders.

Founder Vesting

Founder vesting lets you “earn your stock” as you demonstrate your commitment to the performance of your company. If one or more co-founders decide to back out, your company can buy back their shares.

Anti-dilution Protection

An anti-dilution provision is a clause built into stock options that protects investors against a possible loss of capital. Equity dilution occurs when new issues of a stock are offered at a lower price than those paid by earlier investors.

Exclusivity

After you sign the term sheet and while the investor is doing their due diligence, exclusivity is a standard condition that stops you from talking to other investors for a specified period. The time period is usually between 30 to 45 days.

Term sheets need to be clear and concise to avoid misunderstandings or misrepresentations. It is important to work with an experienced lawyer or financial consultant to help you understand potential risks and negotiate terms.



4 Ways to Ensure Due Diligence Readiness

01. Understand the VC's Investment Process

Every venture capital firm is unique, so it is important to understand how an investor operates. Be sure you are clear on the following questions to avoid any surprises down the road:

- What are their timelines?
- How do they make decisions?
- Who are the decision makers?
- What are their requirements for an investment?

02. Have Your Financials Organized

Have all your financials in order, including up-to-date profit & loss statements (P&L), the cash flow statement (CF), and balance sheets (BS). These are the basic financial statements you will need for any fundraising process.

Profit & Loss Statements: This is essentially an income statement for your business that provides an overview of all the income and costs your company generated in a specific period and whether it was profitable.

Cash Flow Statement: The cash flow statement shows all cash going in and out of your company during a certain period. It is divided into three different parts: the operational cash flow, the investment cash flow, and the financial cash flow.

Balance Sheet: The balance sheet is an overview of everything your company owns (assets) and debts (liabilities) for a specific period.

03. Understand Your Financial Projections

Have a clear understanding of your financial projections, what it will take to achieve your company milestones, and how to communicate your startup's value proposition. One of the best ways to show value to potential investors is through detailed 12 - 36- month financial projections that are optimized to your business model

Startup Financial Projections Are Vital

Projections are the financial translation of your business plan. When properly done, they will show:

- Funding requirements
- Use of funds
- Milestone achievement
- Point of Breakeven and profitability
- Investors return on investment

Financial projections reveal whether startups have a chance to generate enough profit to survive. These insights help potential investors decide if a startup is a worthwhile investment, making them an essential part of any fundraising presentation.

Income Statement	Year 1	Year 2	Year 3
Revenue	152,000	2,345,000	25,795,000
Cost of Sales	98,800	1,876,000	21,925,750
Gross Margin	53,200	469,000	3,869,250
Gross Margin %	35%	20%	15%
Operating Expenses	1,523,000	4,569,000	18,276,000
Net Income	(1,477,400)	(3,162,000)	(219,500)
Headcount	8	23	91

Investors will also use these initial projections to compare the company's actual performance against the original business plan. Thus, the projections need to be well thought out and be as realistic as possible.

04. Prepare Answers to Questions

As part of due diligence, you will be asked a lot of questions about your business. Prepare answers before meeting with investors that demonstrate your knowledge of your market and vision for the future.

Be sure to clearly articulate to investors your:

- Target market
- Competitive landscape
- Business model
- Your startup's value proposition
- Go-to-market strategy
- Business milestones and what it will take to achieve them

Before any money can be invested in your company, the due diligence process is crucial and necessary. Don't rush the process, and don't be afraid to reach out for help.

Hiring an on-demand CFO with experience preparing startups for due diligence and navigating raising capital is a great investment that can ensure your business makes the right moves.

BEFORE YOU SIGN: WHAT TO LOOK FOR IN A VC PARTNER

Your Step-by-Step Checklist

Ideally, you've sought out the right investors who share your vision, created detailed financials that demonstrate your company's value, and you've met with venture capital firms that are interested in funding your startup.

So, now what?

If you've found a potential deal and already begun due diligence, it is still important to ensure you get the best deal possible. Keep reading to find out what you will want to double (and triple!) check before you sign the dotted line.

First and foremost, you'll want to make sure that the terms of the deal are favorable to you. There are a few things that should be non-negotiable, including:

The Amount Being Invested

Carefully review the proposed investment amount before signing. The investment amount should be enough to help you reach your goals, but not so high that you take on too much debt.

Percentage of Equity Being Given Up

Consider the percentage of equity being given up, as well as your startup's valuation. Your valuation amount is how much the VC firm thinks your business is worth. Make sure the valuation is fair and that you're not giving away too much equity in your company.

Deal Structure

A deal's structure is another important aspect to consider. Is the VC going to have much control over your company? Does the VC have board seats or observer rights to the company? It's important to ensure you are comfortable with the level of control they will have.

❑ **Strategic Fit**

If you decide to work with a venture capital firm, make sure it's a good fit. Ideally, you'd like them to have a deep understanding of your industry and support your business. You should feel confident that they have your best interest at heart and can be trusted.

❑ **Team Experience**

The firm must have a team with relevant expertise and experience to avoid last-minute surprises. Ensure you are aligned with the team's vision and that they possess the necessary skills to execute the plan.

❑ **Credibility**

Lastly, you should look at the track record of the VC. Have they been successful in investing in the past? Are they respected in their industry? By researching the VC, you can make sure your investment is wise.

When considering getting VC funding for your startup, make sure to do your research and understand all the terms. Although you may be eager to jump into a funding opportunity right away, jumping into a deal too soon could be disastrous.

The bottom line? Make sure you have a clear understanding of these terms before signing anything.



WHAT'S NEXT?

Strategic Support for Your Company Needs

Now that you've made it through the guide, you know:

- The Pros and Cons of Venture Capital Funding
- How to Source VC Funding
- How to Prepare for Due Diligence
- What to Look for in a VC Partner

Strategic Support for Small Businesses

If you are feeling overwhelmed, know that this is a normal part of the process. Not everything you need to know about venture capital funding can be encompassed in a single guide - which is why our experts are here to help.



Rooled Accounting specializes in supporting small businesses through Outsourced Accounting and CFO Consulting services.

Outsourced Accounting

Managing your financial and accounting operations internally takes considerable time and effort. Our team of specialists at Rooled assists startups like yours with outsourced accounting so you can get back to business and focus on what you do best.

With us as your external financial partner, your company receives knowledgeable financial assistance from qualified staff equipped to support your growth. In addition to reliable bookkeeping and ERP solutions, we streamline recurring accounting operations and free up management time for business expansion.

CFO Consulting

Operating a business while simultaneously fulfilling a CFO role is inefficient, so businesses often hire an on-demand CFO. With their expertise, your startup can grow and develop, while strengthening its financial position - helping you achieve longer-term goals more efficiently!

The CFOs, controllers, and accountants at Rooled can take your company's finances from good to great. Our CFOs have experience working with clients from various industries, including fintech, gaming, e-commerce, and more. Our accountants manage your numbers, while our CFOs help you interpret and understand them.



READY TO TALK NUMBERS?

We would love to get to know you and your business goals. Contact our team today to schedule a consultation.



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