Special Report

FISHING FOR VENTURE CAPITAL

So you want to start a high-tech business

After 20 years as a corporate stiff, your head is bursting with a brilliant, high-technology idea. What you'd really like to do is quit your job, start a company with someone else's cash, and get rich by going public in a few years. Heaven knows, there's plenty of venture capital out there—$40 billion and growing—and Internet-related startups have been especially hot.

But the road to riches isn't so easily traversed. No venture capitalist will give you the time of day unless you take some important steps first.

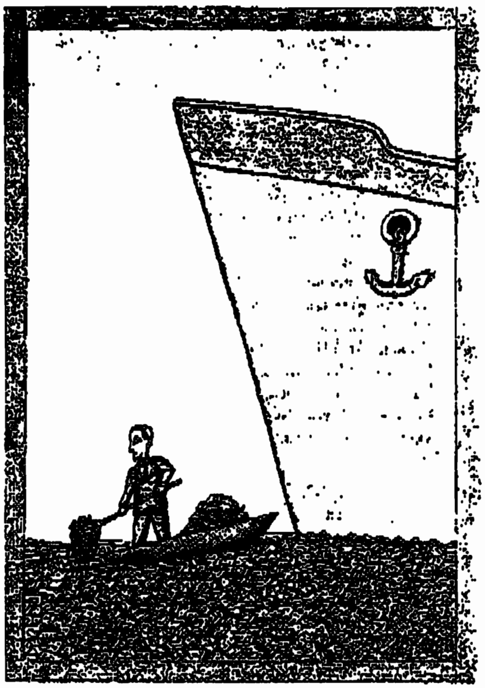
Today's venture capitalists are pickier than ever, and they're interested only in businesses that can deliver annual pretax returns of 32% to 48%. That means you'll have to develop a product, raise your own money, take on partners, and cut deals with suppliers and customers before a venture-capital firm will bet on you. Then, if you grow like mad for three or four years, perhaps you can pull off the initial public offering of your dreams. And keep in mind that of the 6 million companies in the U.S., only 13,000 are public. "If you're an entrepreneur, you're swimming upstream," says Marc H. Morgenstern, managing partner at Cleveland law firm Kahn, Kleinman, Yanowitz & Arnson.

Before diving off on your own, you also need to take stock of your relationships with customers, contacts, and, above all, your current employer. Since your product or service is likely to have grown from your work, chances are your employer will become a partner, a customer, or investor. Such alliances can be golden for a startup.

That's what Neil A. Iscoe is counting on. Now CEO of Focus Systems, a software startup in Austin, Tex., Iscoe came up with his idea for customized law-firm programs while running the advanced-technology division of Electronic Data Systems. He has already raised some money from individuals and hired programmers to create his product. Now, while he races around wooing more investors and hammering out partnerships with Microsoft Corp. and others, he's keeping tight relations with EDS. "I'm hoping to do business with them," he says.

BURN RATES. Most venture capitalists hold onto their wallets until a technology is developed. That means you'll have to rely for your first several hundred thousand dollars on "angels"—everyone from Mom to your old college roommate. And be sure to call a high-tech council in your city or state, and the U.S. Small Business Administration. Lots of government programs provide grants and cheap loans. The National Venture Capital Assn. (www.nvca.org) is a good online source of information.

During this initial period, the rate at which you spend money—the so-called burn rate—can devour your capital like a prairie fire. So offer equity to employees and even suppliers to cut costs. Also, see if you can entice customers to fund your product development. Some might pay you half price now for an early, customized version.



Once the technology is developed and the market scoped out, it's time to talk to venture capitalists. But tread carefully. Headhunter and venture capitalist Jeffrey Christian, CEO of Christian & Timbers in Cleveland, notes that big investors have so much cash these days that they don't want to bother with sums of less than around $2 million. For one thing, a small investment requires nearly as much costly oversight as a big one.

If you're lucky enough to attract some venture capitalists, be aware that your investors are likely to be far more demanding and less forgiving than your angels may have been. They often have clear business models they'll want you to follow. You may spend long nights redrafting business plans to satisfy investors who may never come on board.

During this process, the venture capitalists will be looking into your background. You should do the same with them. Check their success rates, and call other companies they've invested in. Do they provide vital contacts and advice, or do they simply squawk for quicker returns? If you're going to make it to that golden IPO, you'll be relying on venture capitalists not just for their wallets but for their brains.

By Stephen Baker in Pittsburgh

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Finance 101 for Startups

- ☐ Hunt for "angel" investors, including relatives, before quitting your job. You'll need seed money to get the business going.
- ☐ Run the company on a bare-bones basis during the startup, paying employees, investors, even suppliers, with equity.
- ☐ Continue to raise money as you scout out venture-capital firms that have invested in companies like yours—and succeeded.
- ☐ Don't be beguiled by the first venture capitalist to show interest. Keep shopping until somebody actually coughs up money.