Venture Capital Guide

2019

Hamilton Locke

In this Guide

What is venture capital?

What is venture capital?

Overview

What is Venture capital?

Described in basic terms, VC involves the investing in early stage high growth companies that are developing new and innovative technologies and systems. Venture capitalists usually take equity (minority share) in the company and provide capital, commercialisation and strategic skills and insight.

VC is often referred to as “patient capital” because rather than an immediate return to the investor through regular payments of principal and interest, the investor has to wait for its return through long term capital appreciation, realised only after the sale of their shares in the company by way of an IPO or trade sale (typically between 3 and 5 years after the investment).

Key characteristics of a VC investment

- typically have higher risk/return profiles;
- new marketing ideas, innovative technology and new product application potential;
- products which have passed through the early prototype stage and are adequately protected by patents, copyright or confidentiality arrangements;
- businesses with the potential to mature within a few years to the point of an IPO or trade sale;
- opportunities for the venture capitalist to contribute beyond the capital investment;
- high quality executives and employees who are energetic, focused and professional; and
- a significant, although not necessarily controlling, participation by the venture capitalist in the company’s management.

What is venture capital?

Forms of venture capital

Institutional venture capital

involves a fund manager, who raises funds (typically from high net worth individuals and superannuation funds) to invest in a diverse portfolio of companies, often with an industry focus.

Corporate venture capital (CVC)

established corporations making VC investments either via an independent arm of its business or a dedicated corporate division.

University funds

some universities (more so in the US, but also in Australia) have dedicated commercialisation divisions to assist students to take their research to the market.

Government funds

Australian federal and state governments have created dedicated venture capital funds which invest for both commercial and public interest objectives.

What is venture capital?

Traditional debt vs CV finance

	Traditional debt finance	VC finance
Form of investment	The company borrows money which it must repay later, with interest	In return for funds, the investor receives a percentage stake in the capital of the company
Investor's source of return	Interest	Growth in the value of the investor's shares
Return on investment	5 – 10% per annum	An internal rate of return (IRR) of 35 – 40%
Protection for investor	Mortgage and security taken over the assets of the company	Seats on the company's board, preferential shareholder rights, put/call options
Risk	Low (as secured assets can be sold if company defaults)	High (usual profile for VC is high risk for high return)
Considerations for investor	Adequacy of collateral	Management team and market potential of company
Time before investor generates income	Usually 1 month (interest payments)	Typically 2 – 6 years
Means of exit for investor	Loan repayment	IPO or trade sale

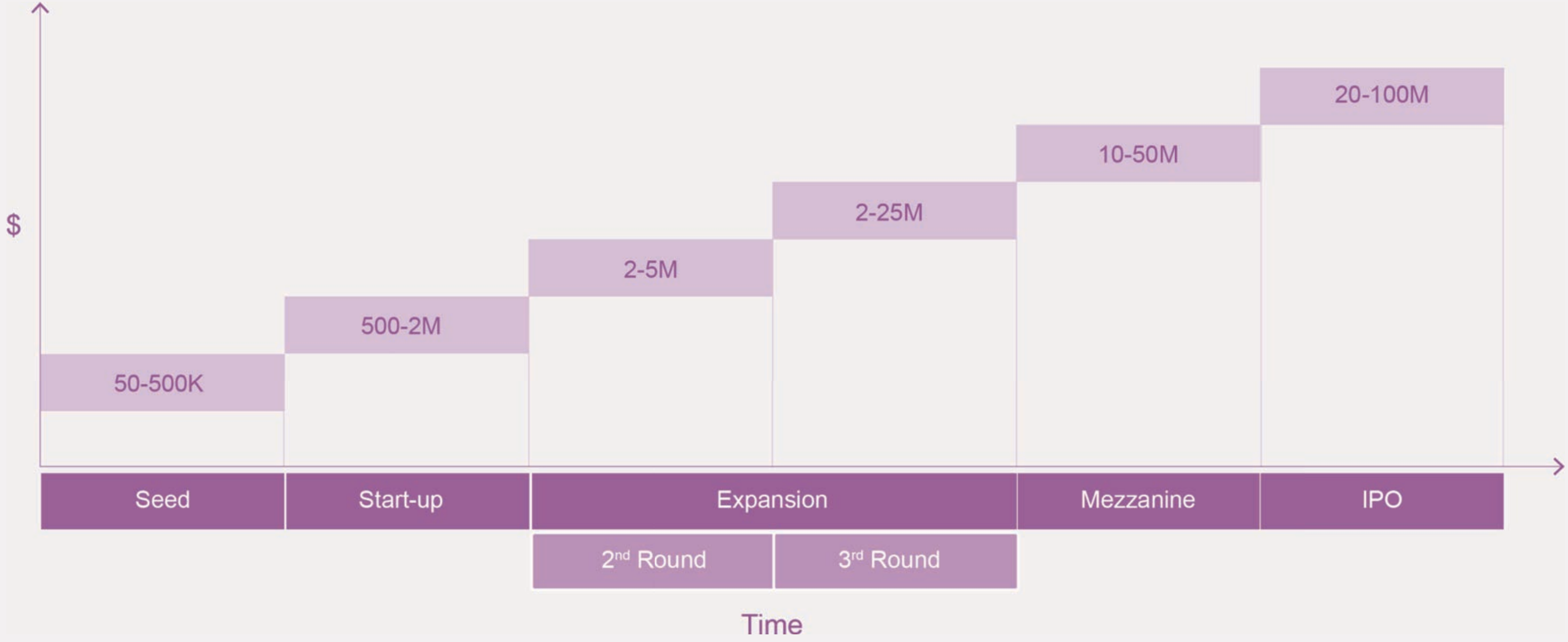
What is venture capital?

Risk and returns

	Stage	Summary	Risk/Return Ratio	Funding Needed
Stage 1	**Seed**	Business idea or concept with product offering still in development	Highly speculative and funding may be in small amounts for an as-yet and unproven concept.	$50,000 to $500,000
Stage 2	**Start-up**	Also known as “Angel Round”. The concept or product has been developed and patented.	Considered the riskiest stage for investors as company requires large amount of capital but has no reliable indicators of its future success.	$500,000 to $2 million
Stage 3	**Expansion**	Also known as “Second Round” and also may comprise multiple rounds.	Company is fully set up and is building a financial track record. Funding required to expand existing operations and marketing capacity.	$2 million to $10 million or more.
Stage 4	**Mezzanine**	Also known as “pre-IPO funding”. Allows a company to prepare an IPO.	Mezzanine Investors are usually just providing experience and funds to “dress up” a company for listing.	$10 million to $50 million or more.

What is venture capital?

Lifecycle & funding



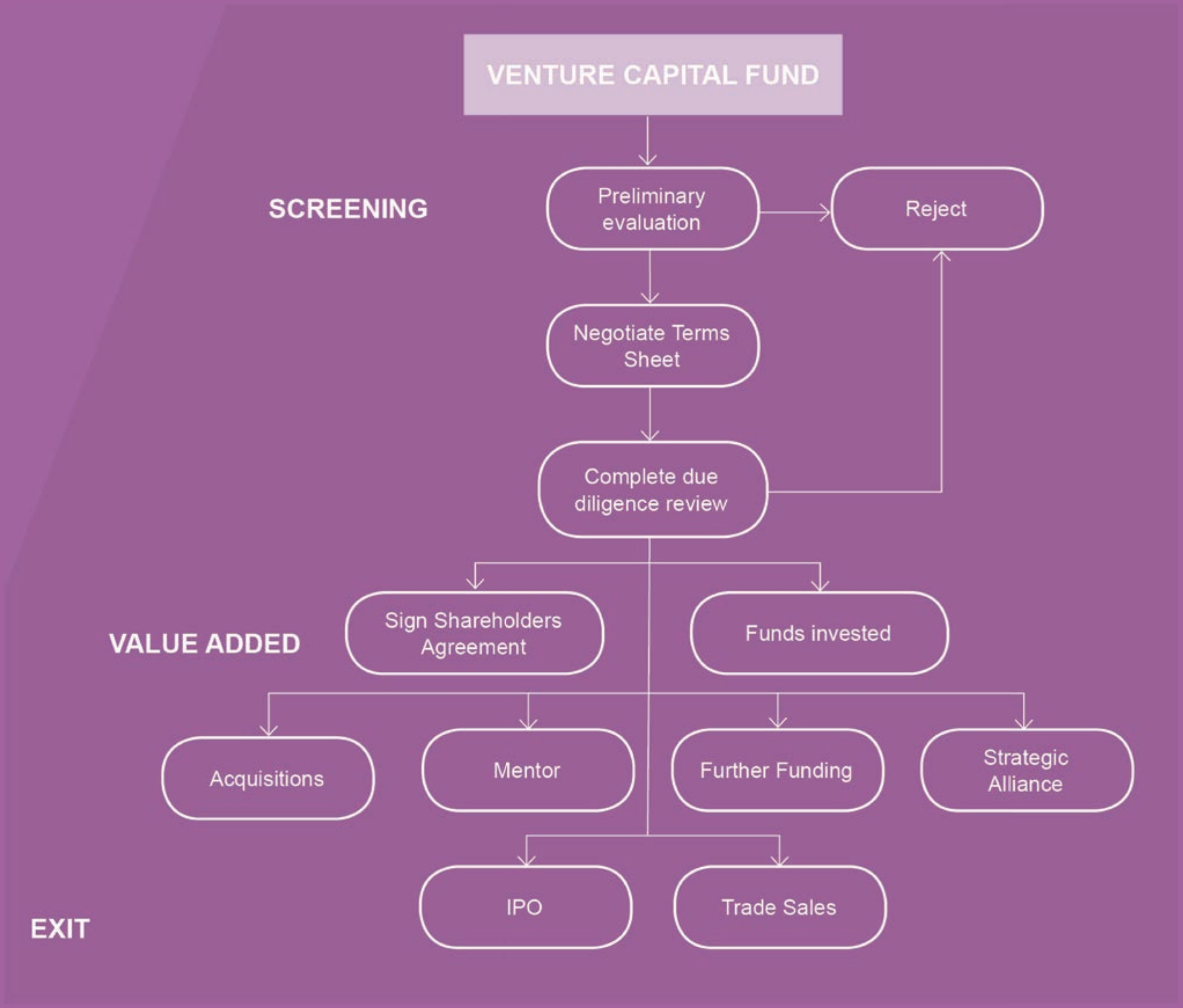
The investment process

The investment process

Overview

Selection of the right type of investment is a very important decision for both entrepreneurs and venture capitalists. And the investment process, a complex one for both.

> 60% of a watermelon, is better than 100% of a grape
>
> *Mark Cuban*



The investment process

Overview

STAGE: Entrepreneur Preparation

STEP 1:
Prepare a business plan

PROCESS INVOLVEMENT:
The business plan should clearly identify the entrepreneur's business opportunity and strategy, by comprehensively and professionally setting out:

- key facts about the business;
- business activities;
- financial plan;
- industry and competition;
- customers and target market; and
- how resources will be used to achieve business objectives.

STAGE: Entrepreneur Preparation / Screening

STEP 2:
Selecting suitable venture capital funds

PROCESS INVOLVEMENT:
An entrepreneur/company should consider:

1. investment preferences of the various funds;
2. quality of the relationship between the management team & investors;
3. the funds' track records;
4. ability of the fund to provide future funding; and
5. value that the investor can add through industry experience, contact networks and expertise in start-up financing.

The investment process

Overview

STAGE: Screening

STEP 3:
Submit business plan

PROCESS INVOLVEMENT:
Sending unsolicited business plans is usually not a good strategy. The best approach is to be introduced by a third party who has an existing relationship with the funds.

STAGE: Screening

STEP 4:
Preliminary evaluation and negotiating valuation

PROCESS INVOLVEMENT:
Once the investor has looked at the business plan, there will be preliminary discussions and interviews to determine whether the company is suitable.

Whilst agreeing on the valuation is important, other factors including restrictions placed on the Founder’s shares, should be considered.

STAGE: Screening / Negotiation

STEP 5:
Negotiate terms sheet

PROCESS INVOLVEMENT:
The terms sheet sets out the basic framework for the deal. Typically, the issues to be resolved at this stage include:

- form of the investment;
- protections to be given to the investors;
- rights of the investors to appoint board representatives;
- pre-emptive rights; and
- exit strategies.

The terms sheet also typically grants the investor an exclusivity period in which to conduct its due diligence inquiries.

The investment process

Overview

STAGE: Screening / Negotiation

STEP 6:

Due diligence investigations by investor

PROCESS INVOLVEMENT:

Once the terms sheet is signed, the investor will proceed with due diligence. This involves a detailed examination of the company to assess the feasibility of the business.

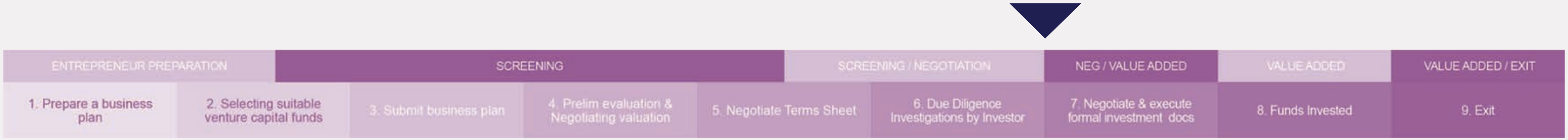
STAGE: Negotiation / Value Added by Investor to Business

STEP 7:

Negotiate and execute formal investment documentation

PROCESS INVOLVEMENT:

Upon completion of due diligence investigations, parties will prepare and execute formal documentation.



The investment process

Overview

STAGE: Value Added by Investor to Business

STEP 8:
Funds invested

PROCESS INVOLVEMENT:
An investor can usually provide (in addition to the funding required by the business):

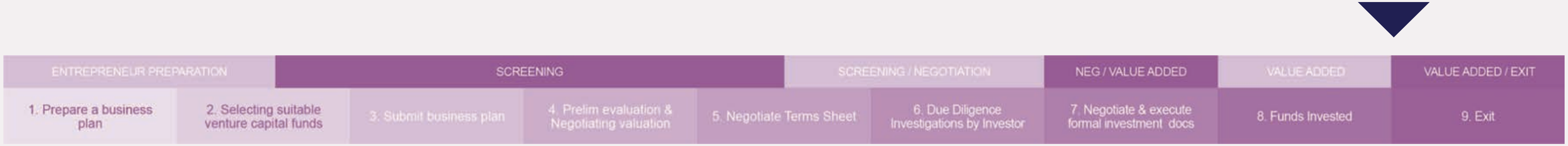
- knowledge, skills and contacts for acquisitions;
- mentoring;
- further funding at a later stage;
- strategic alliances; and
- industry know-how and contacts.

STAGE: Value Added by Investor / Exit

STEP 9:
Exit

PROCESS INVOLVEMENT:
Typically by IPO or trade sale.
Investor usually can provide at this stage:

- knowledge and assistance to dress-up for IPO; and
- further funding.



The investment process

Selecting suitable funds

Most venture capitalists prefer business plans to be limited to no more than 15 to 20 pages, and should set out:

1. **Executive Summary:** maximum 2 pages summarising the essence of the plan.
2. **Table of Contents:** tool for the reader to navigate through the plan.
3. **Background on the Company:** brief history and description of the nature of the business, industry and future direction of the business.
4. **Product/Service:** description of product / service and the unique qualities and stage of product life cycle.
5. **Market Analysis:** industry size (domestic and international) and growth rates, competitors, market share, customers, barriers to entry, barriers to growth, distribution channels, target segments and competitive advantages.
6. **Marketing:** how the product will be marketed, overseas market access issues, pricing plans, sales force, strategies for different markets, distribution channels and how these compare with competitors.
7. **Manufacturing:** description of production process, details of production costs including resources required, capacity and suppliers.
8. **Research and Development:** status of development of the product.
9. **Management:** profiles of key personnel, organisation chart and any additional staff planned and expected remuneration.
10. **Rick Factors:** to company, market and the industry.
11. **Financials:** summary of past and projected performance.
12. **Funds Required:** amount of funds, use of funds, capital structure and ownership before and after financing.
13. **Company Matters:** directors, shareholders, bankers, auditors, lawyers and other advisors.
14. **Appendices:** project brochures, statutory accounts, detailed projections (previous 3 years), resumes, market studies or articles.

The investment process

Selecting suitable funds

It is recommended that the company prepares a short list of suitable funds and requests a copy of their publications to assist in considering the following:

1.	INVESTMENT PREFERENCES	A company should look at the investment preferences of various VC funds, such as: • Particular stages of investment; • Amount of investment; • Industry sectors; and • Geographical location.
2.	COMMUNICATION	As the investment and relationship will typically last a number of years and involve close negotiations and discussions, it is important that the fund selected is one with which the company can build a strong and open relationship.
3.	EXPERIENCE	What other companies in the industry has the VC fund invested in, and their track record?
4.	FUTURE FUNDING	Does the VC fund have capacity to provide further rounds of funding or introduce the company to offshore finance markets?
5.	VALUE ADDED SERVICES	Does the VC fund offer any: • Industry specific knowledge; • Financial and strategic planning; • Recruitment of key personnel; • Acquisition identification; and • Access to international markets and technology.
6.	AVCAL	The Australian Private Equity and Venture Capital Association Limited (AVCAL) has adopted an industry Code of Conduct which established a minimum set of principles that its members must observe. It recommended that the VC fund be a member of AVCAL.
7.	OTHER INVESTORS	It is usual that the company will require further funding. It is also usual for VC firms to co-invest in a deal. Companies should consider whether the venture capitalist would be willing to work alongside other investors.

The investment process

Submitting a business plan

A good approach is for a company to speak to:

- an associate who may have obtained VC financing previously;
- government laboratories and institutions;
- other entities that licence technology to venture- backed companies;
- accountants, lawyers and bankers who advise VC funds or venture-backed companies;
- superannuation fund managers;
- universities; and
- other entities involved in innovation and venture capital.

The VC Fund will undertake a preliminary evaluation of the merits of your proposal, in particular:

- experience of the management team;
- potential for exit;
- profitability of the business;
- outlook for industry;
- competitiveness of the product/services;
- barriers to entry;
- viable business model.

Once the investor has reviewed the business plan, there will be preliminary discussions and interviews to determine the suitability of the investment.

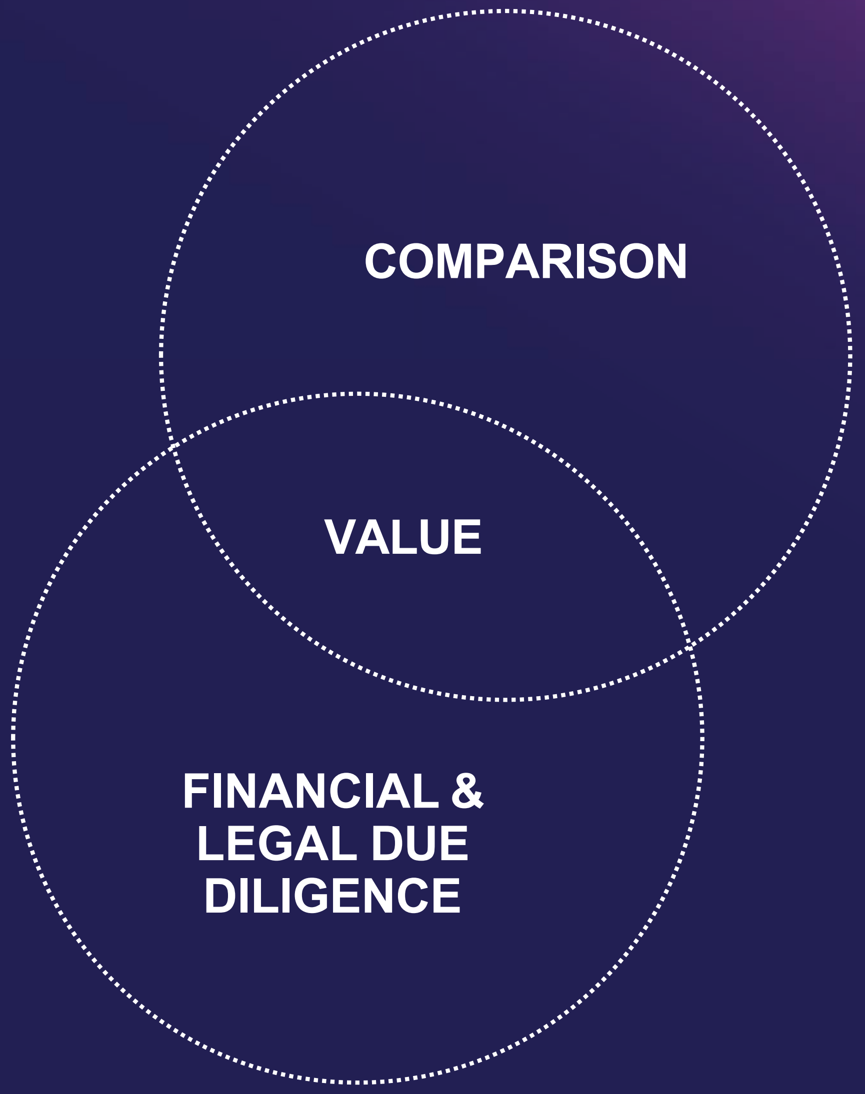
The investment process

Valuation

Valuation of the business

Negotiating valuations is usually one of the most difficult issues in VC financing, this is intensified further in the case of a start-up without any operating history.

Venture capitalists will often use other deals by other companies in the industry and information about comparable companies that have used VC financing, in assessing management's projections. They will typically want any projections and valuations from management to be supported by financial and legal due diligence and based on verifiable assumptions.



The investment process

The term sheets

The framework for the investment will be set out in a terms sheet which records the parties understanding of the key issues and governs the investment until such time as the parties negotiate the detailed legal agreements.

During the negotiation of a terms sheet, companies should bear in mind that it is likely that they will need subsequent rounds of financing, and any future venture capitalists will typically want the same or similar rights as those granted to early-round investors.

1. FORM OF INVESTMENT CONSIDERATION

Consideration for the investment may take the form of ordinary shares, preference shares or convertible notes. Venture capitalists generally want preference shares as they confer additional protection without leveraging the balance sheet. Rights attached to preference shares include:

- preferential right to dividends;
- preferential right on a liquidation or winding up of the company; and
    - right to convert preference shares into ordinary shares at any time.

    Note that many seed round investments sub $1 million in value are now often conducted via a Simple Agreement for Future Equity (SAFE). This is a form of convertible note that is tax equity and which converts in the future to shares when the relevant company conducts a priced capital raise, often at a discount to the share price implied by that raise.

2. SIZE OF INVESTMENT AND TRANCHES

Venture capitalists may wish to make their investment in stages or tranches with each tranche conditional upon the company achieving certain milestones.

3. APPOINTMENT OF DIRECTORS

Venture capitalists will want some oversight and control over the progress of their investment. In order to do this, they will seek to appoint a certain number of directors to the board and tailor the company matters which must be considered by the Board

4. PROTECTION AGAINST DILUTION

There are two types of anti-dilution protection:

(i) Restructures: protection against share dividends, share splits, reverse splits, and similar recapitalisation occurring by adjusting the conversion price of preference shares to ensure that the number of ordinary shares issued on conversion represents the same percentage of ownership.

(ii) Prior protection: if the company issues shares at a discount to shares bought by an investor, the conversion price is adjusted to ensure the number of ordinary shares issued on conversion represents the same percentage of ownership.

5. REDEMPTION

Venture capitalists may seek the right to force the company to realise the value of the investment at some point in the future by requiring the company to buy back or redeem their shares if an IPO or trade sale has not occurred by a certain date.

6. FACILITATION OF SALE OF ALL ISSUED SHARES

Venture Capitalists may also require a “drag along” clause which compels all shareholders to sell their shares if more than a specified percentage of shareholders (usually 75%) accept a third party offer.

7. STANDSTILL FOR FOUNDING SHAREHOLDERS

Venture capitalists may also require that the founding shareholders agree to standstill provision which prevent them from selling their shares in the company for a period of time.

8. EXECUTIVE SERVICE AGREEMENTS

Venture capitalists may require that key executives sign appropriate executive service agreements.

9. INFORMATION RIGHTS

Venture capitalists may want the right to receive certain information to allow them to comply with the reporting obligations of their investment vehicle (such as an Early Stage Venture Capital Limited Partnership (ESVCLP)), such as monthly financial statements, annual audited financial statements, and the annual budget and business plan approved by the board.

10. INTELLECTUAL PROPERTY RIGHTS OF THE COMPANY

Venture capitalists may want assurance that the company has sole legal and beneficial ownership of the intellectual property rights.

11. PRE-EMPTIVE RIGHTS

Venture capitalists may require a pre-emptive right to invest in future issues of shares in preference to a third party.

12. EXIT STRATEGY FOR INVESTORS

Venture capitalists are driven by the need to realise the value of their investment and may seek to impose a provision enabling them to force a trade sale or IPO if such an event has not occurred within 3 - 4 years of the investment.

13. ADDITIONAL MANAGEMENT MEMBERS

Venture capitalists may require the company to recruit additional executives to the management team.

14. EXCLUSIVITY PERIOD

Venture capitalists may seek a period of exclusivity after the signing of the terms sheet, typically 30 to 60 days, where the venture capitalist has the right but not the obligation to invest, and the company is restricted from engaging in negotiations with other potential investors.

The investment process

Due diligence

The detailed examination of the company will run in parallel with the terms sheet negotiations. The venture capitalist and its lawyers will typically undertake due diligence on the following:

1. CORPORATE

Review of the company's:

- corporate structure including subsidiaries;
- business names;
- constituent documents; and
- shares issued and debt securities convertible into shares.

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2. ASSETS

Review of what assets the company owns, including:

- real property;
- intellectual property; and
- contractual rights and intangibles,
- and who owns the assets and any mortgages or charges over them.

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3. INTELLECTUAL PROPERTY

Verification of the company's ownership of the intellectual property.

4. FINANCIAL STATEMENTS

Extensive review of financial statements and accounts of the company will be conducted to assess the past performance and future prospects of the business.

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5. MATERIAL CONTRACTS

Review of the company's key contractual relationships with suppliers and customers, key employees, strategic alliances, licensing agreements and other material contracts.

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6. EMPLOYEES

Review of the company's:

- standard employment agreements;
- relationships with key employees;
- employee option plans; and
- history of any disputes (if any).

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7. LITIGATION

Searches undertaken and review of any actual or threatened litigation or dispute which the company has been involved in.

The investment process

Legal documentation

Although actual legal documentation and agreements vary in relation to the subject deal to be done, in most deals the following documents and agreements are standard:

Subscription agreement

Sets out the subscription details such as:

- number of shares;
- price of shares;
- number of tranches;
- dates of subscriptions;
- warranties about the company;
- rights attaching to shares; and
- any conditions which have to be satisfied before the investment is made.

Shareholders agreement

Sets out the ongoing relationship between the shareholders and the company as agreed in the terms sheet.

Intellectual Property Acknowledgement Deed

Acknowledgement and confirmation by other parties that they have no rights in any intellectual property which they developed and assign all such creations and property (if applicable) to the company.

Executive service agreements

Will bind “key” employees to the company for a period (usually 2 to 3 years) and will set out the employees’ terms of service, remuneration and bonus entitlements. It is usual that these terms will have confidentiality and restraint obligations which apply to key employees during their service as well as post-employment.

Many seed round investments are now made via an instrument known as SAFE. First developed by the Silicon Valley based fund and incubator, Y Combinator, a SAFE is a form of convertible note that is tax equity (and hence an eligible investment for the most common form of VC fund entity in Australia, an ESVCLP) and which converts in the future to shares when the relevant company conducts a priced capital raise, often at a discount to the share price implied by that raise.

The key benefit of a SAFE is that it allows very early stage businesses to raise capital with minimal documentation and no valuation and allows such matters as shareholders agreement terms and initial valuation to be determined at the time when the company is ready to conduct its first priced capital raise.

Exit Strategies

Exit Strategies

Overview

VC investment is considered **"exit-driven"** as venture capitalists are motivated by the need to realise their investment. In terms of this realisation, there are 3 main strategies: IPO, trade sale or redemption of the investor's shares by the company.

1
IPO

2
Trade Sale

3
Redemption

> "Every company needs an exit strategy and an exit plan. Ideally, the exit strategy should be agreed upon by the founders before the first dollar of investment goes into the company."
>
> ***Basil Peters***

Exit Strategies

IPO

An Initial Public Offering (IPO) is, as the name suggests, the very first sale of the company's shares to the public by listing them on a public stock exchange such as the Australian Securities Exchange (ASX) or the National Association of Securities Dealers Automated Quotations (NASDAQ) (an American stock exchange).

An IPO is the favoured exit strategy for venture capitalists and founding shareholders because generally the shareholders in the company can realise their investment and potentially receive very high returns on their original investment.
However, this potential should always be measured against the time and expense usually incurred in the IPO process (which is highly regulated and scrutinised) and in ensuring the company's ongoing compliance with ASX Listing Rule requirements after the IPO.

A guide to the IPO process (the IPO Roadmap) has been prepared by Hamilton Locke and can be accessed here > Hamilton Locke IPO Roadmap 2018. The IPO Roadmap 2018 provides practical and up-to-date guidance on the decision to list, choosing your team, preparation, due diligence and disclosure, the offer and the listing.

Exit Strategies

Trade scale and redemption

Trade Sale

The IPO exit process is expensive and time-consuming but offers potential for a very high return. A trade sale, by contrast, may not offer the same return, but will generally involve less expense, effort and risk.

Redemption

A company can buy back the venture capitalist's shares at a previously specified price or rate of return, triggering a redemption by either the company or the venture capitalist will be contained in the shareholders agreement. Note that this option may not be open to VC funds that are ESVCLPs as they are constrained by strict eligibility rules on the terms of their investments.

Like a trade sale, the potential for return on original investment is not as high as an IPO exit and significantly, the return would be capped at an upper limit based on the previously specified price or rate of return. A company should always consider any redemption rights sought by a venture capitalist and whether the inclusion (and the terms of) that right may hamper the company's ability to raise funds in the future.

Future investors, whether equity or debt, will have concerns about whether their investment is being used to pay out earlier investors rather than grow the business.

Hamilton Locke have analysed the deal trends and negotiation points in M&A transactions here in Australia and in the US in our M&A Deal Data Report 2018 which can be accessed here > [Hamilton Locke M&A Deal Data Report 2018]

How to win venture capital

How to win venture capital

Overview

Many entrepreneurs mistakenly believe that having an outstanding concept and management team is enough to secure venture capital investment. However, venture capitalists see outstanding concepts backed by good management teams every day, and they may have hundreds of proposals and business plans on their desks at any one time.

As noted previously in this guide, much of a company's success will have to do with pinpointing and targeting the ideal VC investment fund and customising the pitch to this fund.

How to win venture capital

Key characteristics

Generally venture capitalists will look for the following characteristics in an investment target:

Superior business: the company's product should have a large potential market with high growth prospects, and be a product which is easily differentiated from its competitors. The market should have barriers to entry so that the company's strategic position is defensible.

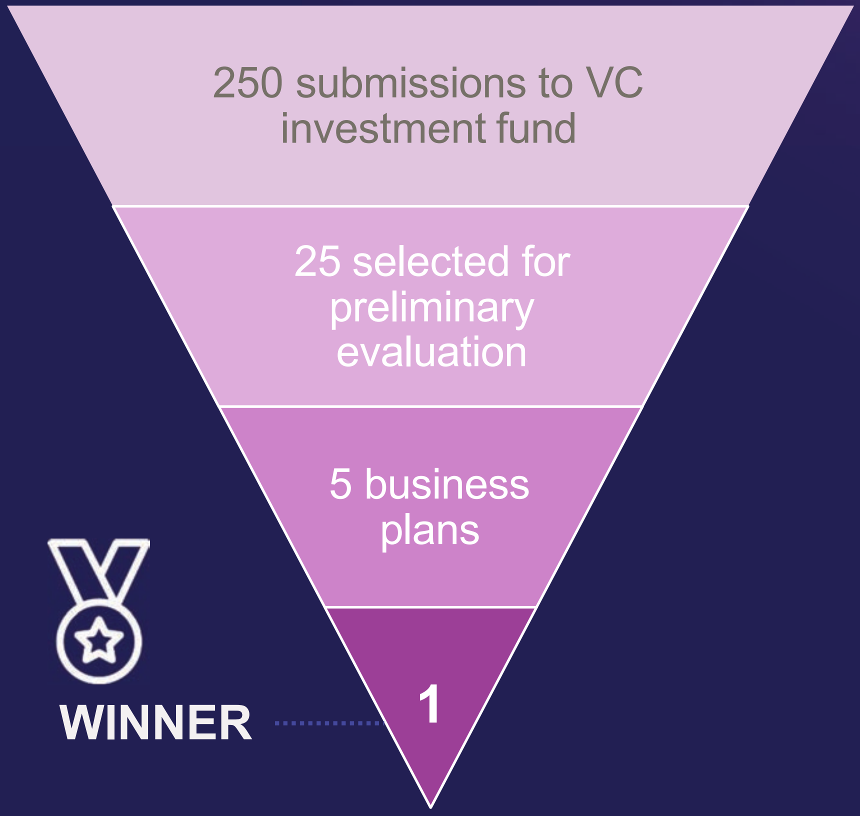
Quality and depth of management: it is said that venture capitalists will, like seasoned punters, "bet the jockey, not the horse". A company should assemble a balanced team of professionals and management with the all-round experience to accomplish the objectives set out in its business plan.

Corporate structure: a venture capitalist will look for a clean corporate structure, rather than having a widely diversified shareholding and also clear distinction between company's assets and those assets still held by founding shareholders.

Intellectual property: an investor will want to ensure that the company has clear and indisputable rights and ownership of the intellectual property prior to investing funds in the company.

Investment structure: the investment structure must allow the investor to generate high returns which justify the risk of the investment, often by providing an easy exit strategy where reasonably permissible.

Typical process of elimination by venture capitalists



How to win venture capital

EVCI

VENTURE CAPITAL LIMITED PARTNERSHIP (VCLP)	EARLY STAGE VENTURE CAPITAL LIMITED PARTNERSHIP (ESVCLP)
The VCLP has a general partner who manages the fund, and limited partners who invest money. The limited partners have limited liability and are not involved with the day-to-day management of the fund. Income and capital gains earned by eligible limited partners may be exempt from tax.	An ESVCLP is a venture capital fund structured as a limited partnership that makes equity investments in eligible Australian start-up and growth companies. Under the program, a fund manager can raise an early stage venture capital fund that pools investors' capital. An ESVCLP's investors are exempt from income tax on their share of returns (income or capital) when an ESVCLP disposes of an eligible venture capital investment (EVCI) and on any other income earned from the EVCI such as dividends (See next slide for more details on EVCI).
Eligibility	
To be eligible for the tax incentives, a VCLP must be registered and remain registered as a VCLP under the Venture Capital Act 2002 (Cth). Key registration requirements: • The partnership is structured as a limited partnership, established in Australia or in a country with which Australia has a double tax agreement. • All general partners are residents of Australia or residents of a country with which Australia has a double taxation agreement. • Fund term of between 5 and 15 years. • The partnership must have at least $10 million committed capital.	To be eligible for the tax incentives, a ESVCLP has additional registration requirements including: • The partnership must have between $10 million and $200 million committed capital. • ESVCLP must be a stand-alone fund and not part of a larger fund. • Investments made by the partnership must be in accordance with an approved investment plan. • The investee entity is not listed when the partnership makes its first investment in the entity. • Any investments acquired from existing investors must add to an investment already held in the entity or issued in connection with that acquisition, and which in total do not exceed 20% of the partnership's committed capital. • The total asset value of the investee entity before the investment is made is not more than $50 million.
Benefits	
• Flow-through tax treatment for a VCLP. • An exemption for eligible foreign venture capital limited partners from income tax on capital and revenue profits from the disposal of eligible venture capital investments by the VCLP. • That fund managers are taxed on their carried interest in the partnership on capital account, rather than as income.	• Flow-through tax treatment for ESVCLP. • An exemption for Australian and foreign venture capital partners from income tax on capital and revenue profits from the disposal of eligible venture capital investments made by the ESVCLP and any other income earned on these investments. • That fund managers are taxed on their carried interest in the partnership on capital account, rather than as income. • Additional tax incentive for limited partners in new ESVCLPs – investors will receive a 10% non-refundable carry- forward tax off-set on investments made through new ESVCLPs.

How to win venture capital

EVCI

Broadly, for an investment to be an eligible venture capital investment (**EVCI**), the following key requirements of the *Income Tax Assessment Act 1997* need to be satisfied:

VENTURE CAPITAL LIMITED PARTNERSHIP (VCLP)

- A VCLP has no maximum fund size. Capital commitments are unlimited.
- A VCLP may only invest in shares or units (typically at least 80% newly issued) or options or convertible notes of an investee that:
- is located in Australia, as defined above;
- has total assets of no more than A$250 million;
- has a predominant activity that is not property development, land ownership, finance, insurance, construction or making investments aimed at deriving passive income (The 2016 Budget papers indicated that the Government would ensure that the venture capital tax concessions are available for FinTech, banking and insurance related activities); and
- is not listed or is de-listed within 12 months after investment.
- Both ESVCLPs and VCLPs have a single investment limit equivalent to 30% of committed capital.

EARLY STAGE VENTURE CAPITAL LIMITED PARTNERSHIP (ESVCLP)

- An ESVCLP has a maximum fund size of $200 million committed capital.
- ESVCLP may typically only invest in shares or units (typically at least 80% newly issued) or options or convertible notes of an investee that:
- is a business in its early stage of development;
- is located in Australia, typically defined as having at least 50 percent of assets and staff being located in Australia for at least the first 12 months of the investment (investments of up to 20% of committed capital may be treated as eligible even though the location test is not met);
- has total assets of no more than A$250 million (“Permitted Entity Value Test”);
- has a predominant activity that is not property development, land ownership, construction or making investments aimed at deriving passive income, typically requiring that eligible activities account for more than 75% in relation to two or more of the investee's assets, employees and income (“Predominant Activity Test”);
- is not listed on a stock exchange at the time of investment; and
- complies with the other requirements of the ESVCLP's investment plan.

IN RELATION TO BOTH:

- Investments must be at risk and held for at least 12 months. Debt investments are only permitted to accompany eligible equity investments, or for bridging purposes for less than six months.
- The fund may hold assets using a holding company formed for that purpose. From 1 July 2016, the rules became more flexible in relation to investee holding companies with multiple subsidiaries.
- An investee of an ESVCLP or VCLP can make "bolt-on" acquisitions of new, complementary businesses, without affecting the eligibility of the ESVCLP's or VCLP's investment for a specified period to allow time for the acquired business to comply with the eligibility criteria.
- A registered auditor must be appointed as its auditor for the year the investment is made and all future years.

Conclusion

Venture capital is considered the muscle behind innovation because it involves more than just the provision of financial accommodation to a company. Venture capitalists specialise in different industries, growth stages and risk profiles, where they can add value in specialist skills and mentoring which best fit the company's needs.

Companies should consider whether it is VC that they are seeking. As outlined in this guide, VC firms will tend to work throughout the life cycles of a company and are very much involved in the operational structure. Venture capitalists have a strategic role in the company and will likely seek to have a clear involvement with the company in order to stay close to their investment and to ensure that they are able to contribute to major decisions that could impact their returns in the long run. However, a company should seek to understand the value a venture capitalist brings by doing its due diligence in order to really understand if a venture capitalist is going to add value in addition to capital, and whether the expertise of the venture capitalist is synonymous with the requirements of the company.

The risks for both the company and the venture capitalist is tremendously high and despite the televised portrayal of a smooth and swift process, it is a long and complex transaction. Given the risks and complexity of the deal, it is critical that companies are aware of the issues raised in this guide and assess the impact those issues may have on the future of the business.

Trend report

Trend report

The rise of venture debt

Venture debt lending has long been a feature of the US venture financing landscape but is belatedly starting to feature in Australia with the recent launch of two Australian based venture debt shops. Venture debt involves the provision of debt finance to typically later stage start-up companies that is used as equity round replacements or for milestone financing, working capital or M&A activity.

Venture debt will be appropriate for later stage start-ups that are producing revenue and for enterprises that require funding through the growth phase of their development but are not yet able to obtain finance from traditional lenders.

Term loans and convertible notes are often the instruments by which the debt is provided. Warrants may also be granted to the financier to provide potential equity upside as a sweetener for the financier accepting higher levels of risk by lending to an early stage company.

The optimal time for a business to raise funds is often immediately following the achievement of a key milestone that increases a company's valuation, resulting in less equity dilution for the same amount of capital raised. Venture debt can extend the cash runway of a start-up company to its next valuation driver, thereby giving the company space to increase in value in the meantime. A subsequent equity round can then be raised at a higher valuation. Management, employees and investors can all benefit from less dilution and investors can benefit from less cash required to maintain their ownership position.

Trend report

Record highs – VC investment increase

Australian venture capital has reached new highs with US$630 million invested in the Australian market in the 2017-2018 financial year, despite a fall in deal volume from 31 deals to 27 deals in Q2 2018.

This follows a US and global trend of record highs with:

- global investments of US$69.8 billion (across 3,108 deals) in the second quarter of 2018; and
- US VC investment increasing by 4% in Q1 2018 and another 2% in Q2 2018, while VC deal volumes continue to decline.*

Shift towards later-stage start-ups: In Australia (following the global trend) larger VC investments continue to shift towards later stage start-ups over seed investments. Late-stage companies were involved in only 7% of Q2 2018 venture investment deals but received 64% of the VC.

This explains in part, the record high VC investments experienced in Q2 2018, as later stage investments are usually significantly higher to reflect the funding needs of the company at these later stages of their life-cycle (see Diagram 1: Business Lifecycle and level of funding usually required)**

Artificial intelligence technologies: The myth is that venture capitalists invest in good people and good ideas. The reality is that venture capitalists invest in good industries. Artificial intelligence technology (AI) and machine-learning driven automation has and continues to receive substantial VC investment in Australia and globally. This trend is consistent with the utility and demand for AI and automation technology across various businesses and different industries as well as governments.

Corporate venture capital increases: Corporate participation in VC deals globally reached a record of 22% of the total $69.8 billion recorded for Q2 2018. This is consistent with the interest in AI technologies and other innovative technological solution-based processes, to which corporates are seeking to gain exposure and supplement in-house research and development.

Shift towards later-stage start ups

Artificial intelligence gains substantial VC investment

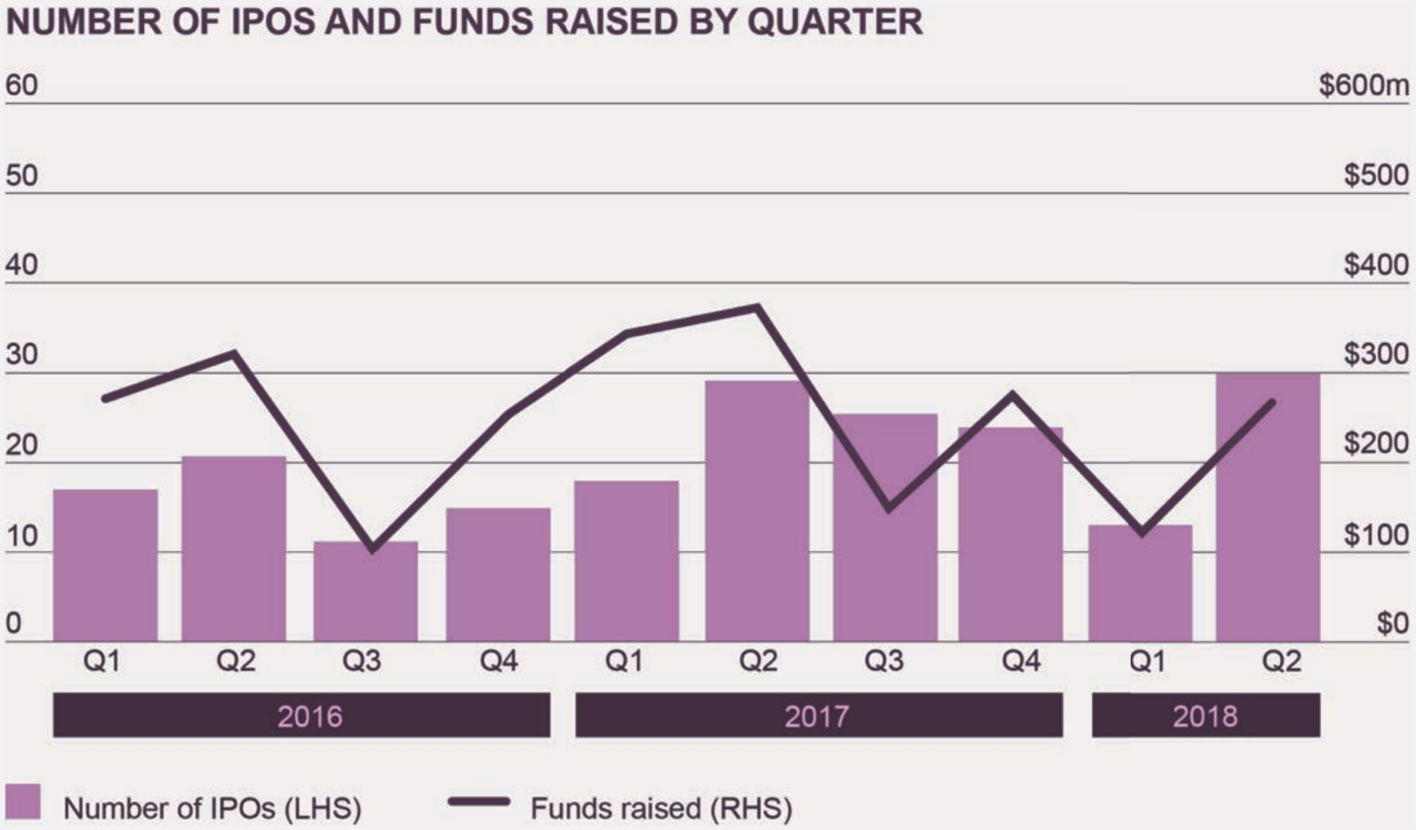
More corporate participation

Trend report

IPO exit activity

It is not surprising, with IPOs typically being the favoured exit strategy for venture capitalists (due to the potential for very high returns on original investments), that the IPO markets in the US, Australia and Asia have reported to have gained strength during Q2 2018, despite a drop in Q1 2018.

The decline in the Australian market (specifically in Q4 2017 and Q1 2018) has been reported to be largely a result of interest rate increases and global political and economic uncertainties, however it is predicted that positive exits by DocuSign and Zuora, combined with strong IPOs by Dropbox and Zscaler, will significantly renew the interest in IPOs generally and as a favoured exit strategy over trade sales.



Source: https://nexia.com.au/sites/default/files/2018-01/IPO%20Report%20-%20Q2%202018%20FY%20-%20January%202018.pdf

About Hamilton Locke

About Hamilton Locke

Hamilton Locke is a corporate law firm specialising in complex corporate finance transactions, including mergers and acquisitions, private equity, capital markets and distressed investing.

WORLD CLASS CAPABILITY

Our team has 6 partners and 15 lawyers who all joined us after careers in top-tier Australian and global law firms

GREAT VALUE

We develop the best pricing approaches with our clients to strike the right balance of fairness, certainty and risk-sharing

CUTTING EDGE EXPERIENCE

We have advised on hundreds of iconic, cutting-edge corporate deals and in the last 24 months advised on deals with a value totalling $3 billion

THE BEST APPROACH

We invest time at our cost to understand our clients' objectives, risk appetites and operating styles

DEEP SECTOR EXPERIENCE

We have experience in a broad spectrum of industry sectors, including retail, financial services, technology, food and agribusiness and healthcare

Venture capital experience

Macquarie investments into Temple & Webster, Brandscreen	Investment into IPScape	Investment into SigNav	Investment into Speedscan	Acquisition of brandsExclusive by APN	MyNetFone acquisition of GoTalk and Symbio Networks
Investment into Building IQ	Wattwatchers investment from CEFC	Moelis Australia in investment in sparesbox	Tank Stream Ventures investments including Go1, BugHerd, pocketbook and School Places	SingTel Innov8 and Yuuwa Series A fundraise into Dealised	Investment into Effective Measures
Sale of MIA Technology to Mandalay Digital LLC (content management application technology)	Giant Leap Fund investment in Perx	Acting for SoAho Property App in its establishment, SAFE and Seed round capital raisings	Tank Stream Ventures investments including Equitise, Firefly Inc, GoCatch, Biteable and Your Grocer	Macquarie investments into Freestyle Technology, Next Payments, Record Point	Bridgelane Capital investments in Flare and a confidential technology investment

Our team

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Our team have top- tier DNA and have worked around the world in New York, London, Moscow, Singapore and Dublin

What our clients say

I have worked with Nick on various transactions over the past 15 years who I have no hesitation in recommending for his M&A/private equity advisory services. He is hands on, responsive, commercial, solutions orientated and has added a huge amount of value to the transactions he has assisted me with over the years; and great to work with!

Bevan Elliott, Investment Director
Anacacia Capital

We've been working with Hamilton Locke since the start of our business and they've been absolutely amazing in catering to our every need. From small projects to the very large, the team have always applied their best advice and experience to ensure that they achieve the best outcome for all our business needs.

Jonathan Lui
Founder of Soho Property App,
co-founder of Airtasker,
partner of Tank Stream Ventures

Nick Humphrey is a veteran of the Australian M&A and PE market, at the top of his game…cuts through the legal issues, a highly skilled negotiator with a personable style…a deep understanding of the commercial drivers and deal risks in M&A, is a strategic thinker and has skillfully navigated our clients successfully through extremely complex issues. His M&A team is quickly building a reputation as a leading mid-market firm with 'New York style' client service and 'innovative' deal structuring.

Tony Garrett, Partner & Head of M&A Advisory
Deloitte Australia

Negotiations were long and protracted, but throughout the entire process we consistently received sound, timely, and commercial advice. [The] team…worked tirelessly and professionally.

Gary Stead, Australia Country Head
Olympus Capital

We…rate the team] highly for skills across a range of areas. We also value commerciality and cost effectiveness...again delivered a first class legal result, understood the commercial drivers and efficiently managed costs.

Todd Barlow, Managing Director
Pitt Capital Partners

Nick Humphrey is one of the most experienced M&A lawyers in Australia and a renowned dealmaker… bring[s] parties together to cut through deadlocks and gets the deal done. A fantastic problem solver and is always coming up with solutions to potential deal-breakers…great coverage of deal flow in the mid-market and use[s] broad networks amongst investors, financiers and growth company CEOs to help originate transactions. [The] team has a great reputation as providing top-tier style advice to the mid-market…. also successfully driving innovation in legal services by deep partnering with clients and alternative billing practices.

Robert Read, Managing Director
Harbert Australian Private Equity

Initiatives

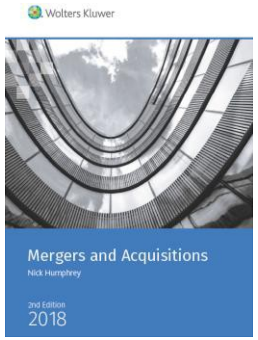
Australian Growth Company Awards

Launched in 2012, the Australian Growth Company Awards celebrate excellence in the mid-market. They recognise companies that demonstrate high rates of growth, as well as innovation, integrity, contribution to community and sustainable growth.

The awards are proudly co-sponsored by Hamilton Locke, Macquarie Capital, Deloitte, Intralinks, GlobalX, NAB and 2020 Exchange.

Mergers and Acquisitions

Mergers and Acquisitions, written by Nick Humphrey, is a plain English reference guide mergers and acquisitions and buyouts with step-by-step advice on the key legal, tax and structuring issues when implementing transactions.



This comprehensive text also includes chapters on equity funding, IPOs, distressed buyouts and preparing for exit.

Published by Wolters Kluwer, it can be ordered online at https://shop.wolterskluwer.com.au/

Hamilton Lock IPO Roadmap

The Hamilton Locke IPO Roadmap is a plain-English, easy to follow reference guide with step-by-step advice for businesses. It provides practical and up-to-date guidance on the decision to list, choosing your team, preparation, due diligence and disclosure, the offer and listing.

Hamilton Locke M&A Deal Data Report

The M&A Deal Data Report is a survey of deal trends in Australia and the US across a range of metrics including warranty caps, earn-outs and purchase price adjustments.

Awards and recognition

Asia Law Profiles Highly Recommended M&A & Private Equity 2014, 2015, 2016	**Best Lawyers** Venture Capital 2009 to 2018 NICK HUMPHERY	**Doyles** Leading Corporate/ M&A Lawyers NICK HUMPHERY HAL LLOYD	**Chambers & Partners: World's Leading Lawyers** 2012- 2019 Private equity: Australia, Key individuals NICK HUMPHERY	**Legal 500 Asia Pacific** 2014, 2015, 2016, 2017 Ranked in corporate and M&A Australia	**IFLR Guide to the Word's Leading Private Equity Lawyers** 2008 - 2016 NICK HUMPHREY	**Euromoney Expert Guides to the World's Leading Lawyers** Banking, Finance and Transactional Law Expert Guide 2018 – Private Equity NICK HUMPHREY
ACQ Global Awards 2016 & 2017 M&A Law Firm of the Year and M&A Lawyer of the Year NICK HUMPHREY	**Acquisition International M&A Awards** Best in M&A and Venture Capital Legal Services 2015 Dealmaker of the Year 2014 & 2015	**Lawyers Weekly Australian Law Awards** Finalist – The Partner Award 2013 & 2017	**The Corporate LiveWire M&A Awards 2015** Most Outstanding Private Equity Lawyer – Australia NICK HUMPHREY	**Australasian Lawyer's Hot 40** 2014 NICK HUMPHREY	**Lawyers Weekly Australian Law Awards** Finalist – Dealmaker of the Year 2015 M&A Transaction Team of the Year 2015	**Best Lawyers** Distressed Investing & Debt Trading, Venture Capital, Private Equity HAL LLOYD

About us

EVOLVED

We have adopted a corporate structure, allowing us to take third party capital to invest in people and systems. Every associate, lawyer and staff member is an owner focussed on long term value. The care of one owner is worth ten employees.

SYSTEMS

We have invested in state-of- the art systems to automate, offshore, process map and outsource to deliver the most efficient and effective service for our clients.

PX / CX

We are driven by maximising people experience (PX) and creating a vibrant culture. We believe strong PX drives the best possible client experience (CX), so we focus on creating a great work environment of learning, teamwork and collaboration, underpinned by a values-based leadership model.

ALLIANCE

Hamilton Locke has entered into a strategic alliance with global law company Elevate, giving the firm access to Elevate's 500+ lawyers, engineers, consultants and business experts to extend and enable the firm's capabilities.

About us continued

FLEXIBILITY

We have the flexibility to offer alternative fee arrangements (e.g. retainers, risk sharing, discount/premiums for broken deals, fixed pricing and equity for fees) on a deal by deal basis.

CHALLENGER

As a challenger brand, we recognise that we must provide exceptional service, find creative solutions and deliver smart advice. We hire and develop the best and brightest talent from top tier firms around the world.

PARTNERING

We have a true partnering model, working with clients and advisers to build long term relationships, where we originate opportunities solving our clients capital and strategic needs. We have successfully closed a number of deals where we played a key brokering role (by introducing equity investors, buyers for their business).

TECHNOLOGY

We have built a people-centric business from day one. By making use of modern systems and technology, our team are freed up from bureaucracy and administration to really focus on doing what they do best – solving complex client problems.

Thank you.

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Hamilton Locke