
HELARCTOS VENTURES: INVESTING IN SEED-STAGE START-UPS

Matthew Wong wrote this case solely to provide material for class discussion. The author does not intend to illustrate either effective or ineffective handling of a managerial situation. The author may have disguised certain names and other identifying information to protect confidentiality.

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“Okay, great. Why don’t you guys work a bit on those customer acquisition costs and we’ll reconnect in a few days?” Ajay Joshi said as he wrapped up a call with the founder of one of the latest start-ups that Helarctos Ventures (HV) was investing in. Joshi put his phone down and pulled up the start-up’s file on his laptop. He added a new note: “The team is fantastic, but the product needs work; their engagement and cost metrics were brutal.”

A 30-minute calendar reminder notice popped up on Joshi’s screen. He was due at an off-site meeting soon. Still deep in thought over the conference call, Joshi quickly crossed the floor of HV’s Toronto, Canada, offices to the compact kitchen, poured himself some water, and returned to his desk. As a partner at HV, Joshi spent time with the team evaluating and advising early stage companies in the rapidly expanding North American technology (tech) start-up scene. HV was a rising seed-stage venture capital (VC) investment firm, and there was no shortage of entrepreneurs looking to join HV’s portfolio of companies.

Although Joshi and the HV team were experienced entrepreneurs and investors with some past successes, HV could not afford to rest on its laurels, as the landscape was dynamic and evolving. They needed to continuously re-evaluate their process and approach. Did they have the right investment criteria? Were they looking at the right things for predicting future growth and success? Were they attracting and matching with the right companies? Each investment in a start-up was a major decision and represented a significant and long-term allocation of finite capital, time, and energy. Joshi and HV needed to be sure, when surety was in short supply. Deciding on the right criteria for evaluating investments was absolutely essential.

VENTURE INVESTING IN CANADA

In the early 2000s, tech start-ups in Canada faced a dearth of investment opportunities, in part because of the country’s tax and investment regulations and in part because of the sector’s aversion to risk.¹ However, since 2010, the VC and private equity (PE) market in Canada had expanded dramatically. Spurred on by changes in federal regulation, increased globalization, and shorter tech development cycles, the Canadian landscape had evolved. Both Canadian and US VC and PE firms had begun to invest heavily in new Canadian tech start-

¹ Shane Dingman, “Toronto’s Tech Startup Scene in a ‘Blossom State,’” *Globe and Mail*, February 14, 2016, accessed October 17, 2018, www.theglobeandmail.com/technology/torontos-tech-startup-scene-in-a-blossom-state/article28755915.

ups. Companies like Shopify Inc., Hootsuite Media Inc., and Kik Interactive Inc. had proven the ability of Canadian entrepreneurs to build and scale global technology companies.

A sophisticated start-up ecosystem had emerged in Canada. Numerous incubators and accelerators, including Communitech Corporation, Propel Entrepreneurship Centre, and the Creative Destruction Lab, had developed in the last several years. These groups were often partnered with universities, helping to grow start-ups from student-based projects. Further, indicative of the global market, international interest permeated the Canadian ecosystem as organizations like 500 Startups and the C100 Association helped to grow start-ups. Local, grassroots efforts such as TechToronto Organization (TechTO) and Startupfest also helped to build awareness and expertise, which cultivated a comprehensive interest in entrepreneurship at all levels.

The Canadian investment community included private VC firms, public funds (e.g., pension, retail, and corporate), and government funds (provincial and federal). According to the Canadian Venture Capital and Private Equity Association (CVCA), an industry representative group, the VC investment landscape had significantly improved in Canada. In 2015, 536 investment deals completed with a total of CA\$2.3 billion² of venture capital invested in Canadian companies.³ Ontario, Quebec, and British Columbia were the three largest investment provinces. The number of deals had also been steadily rising over three years, with 367, 433, and 536 deals done in 2013, 2014, and 2015, respectively. Similarly, the amount invested rose, with approximately \$1.9 billion, \$2.02 billion, and \$2.3 billion invested during those years. The CVCA reported that in 2015, Internet software and services accounted for 59 per cent of the deals completed; 16 per cent were in e-commerce, and the rest were relatively evenly distributed among electronics and semiconductors, mobile and telecommunications, software (non-Internet/mobile), and computer hardware and services.⁴

In 2016, the CVCA reported a similarly strong VC investment year, with \$3.2 billion invested in 530 deals.⁵ Eleven “mega deals” alone—each worth \$50 million or more—totalled \$1 billion. Ontario and Quebec remained the leading investment provinces. Information and communication technology continued to be the dominant VC investment sector, with \$2 billion of investment in 330 deals.⁶

HELARCTOS VENTURES

Founded in 2013, HV was an institutional seed-stage investment fund, managing \$25 million. HV had invested in 28 companies, six of which had subsequently been acquired by other companies. As a seed-stage investor, HV specialized in early stage ventures that may have had core business products or services but not necessarily commercial operations. As a result, seed-stage investment was more speculative than other rounds of investment but could be critical to bringing a start-up out of infancy.

A VC fund that contributed at the seed stage was typically the first institutional investor. Past the start-up phase, institutional investors might follow with additional rounds of funding as the company scaled up for growth. These rounds, called Series A, B, and, possibly, C (and beyond), generally addressed particular functions in the upward trajectory of the company. For example, Series A funding might help with distribution or new markets, while Series B might be focused on team growth, geographical expansion, or

² All currency amounts in Canadian dollars, unless otherwise indicated.

³ Canadian Venture Capital & Private Equity Association (CVCA), “Canadian Venture Capital and Private Equity Activity Way Up—CVCA Report,” press release, February 22, 2016, accessed October 17, 2018, www.cvca.ca/wp-content/uploads/2016/02/CVCA-2015-market-overview-press-release.pdf.

⁴ Ibid.

⁵ Canadian Venture Capital & Private Equity Association (CVCA), “Record-Breaking Quarter: 2016 Canadian VC Investment Nearly Doubles 2015 Results,” press release, May 18, 2016, accessed October 17, 2018, www.cvca.ca/wp-content/uploads/2016/02/CVCA-Q1-2016_News-Release_FINALENG.pdf.

⁶ Ibid.

acquisitions. Series C and onward represented the additional capital needed to scale the business. Beyond these stages, companies might seek to become public through initial public offerings (IPOs). IPOs typically raised even more capital from the public markets in exchange for shares in the companies. If a company remained private, it might seek capital funds from PE firms.

VCs often specialized in particular industries or domains, such as software start-ups, biotechnology, pharmaceuticals, engineering, or robotics. This specialization was typically related to the VC partners' core experience, knowledge, and expertise, as well as their networking breadth and depth. These core characteristics would help inform a VC's "investment thesis"—the investors' beliefs, which guided their investment decisions. HV's thesis focused on three main areas: disruptive mobile-first products, software-as-a-service (SaaS) model companies, and high-potential frontier technologies.

HV was founded by its managing partner, Joe Boseman, who had a bachelor's degree in economics from Wilfrid Laurier University and law and masters of business administration degrees from the University of British Columbia. Boseman had worked as a corporate lawyer before he became director of new ventures at Ionon Ventures, an early start-up incubator in Canada. He left Ionon to found an early mobile content deployment company, which Boseman ran for a number of years. Eventually, he left that company to become a partner at a different VC fund. Finally, desiring to start his own investment fund, Boseman had founded HV in 2013.

Joshi had graduated from the University of Waterloo with a degree in computer science in 2004. Originally a software developer, Joshi got a job soon after graduation at Boseman's company. They began working closely together on sales and management of strategic accounts. Joshi left this company a few years later to found his own company, focused on mobile gaming. Mobile had always been a core focus for Joshi. He recalled that, even as early as 2004, he had known that mobile was going to take off; however, "it took a few more years than I expected." Over the next few years, Joshi would grow his company to 70 employees, having to split his time between his Waterloo, Canada, office and Silicon Valley. Joshi's company would later be acquired by a much larger mobile gaming company. After the acquisition, Joshi felt that it was the right time to start looking for new opportunities.

In late 2014, Boseman, who had kept in touch with Joshi since their time working together, was looking to bring on a new partner at HV following the launch of its second fund. In April 2015, Joshi joined HV as a partner.

DECIDING ON INVESTMENTS

Analyzing the Opportunity

When considering a possible new investment, Joshi and the HV partners primarily scrutinized two main areas: the opportunity and the team. When considering the opportunity, they looked at a number of criteria, including market size; product domain and focus; defensibility; and vision.

Market Size

One of HV's core concerns was the potential market size of the opportunity and whether the start-up presented a "venture-scale" market opportunity. The term *venture scale* referred to both the total addressable market (TAM) and the company's strategies for that market. The TAM was a metric that broadly referred to the size of the market, estimated in terms of the total market demand for a product or service. A TAM calculation might also include a revenue or sales projection if the company hypothetically owned 100 per cent of the

market. The greater the potential market size (i.e., the greater the number of potential customers), the better the opportunity for the start-up and HV.

Truly new opportunities were particularly valuable because of their ability to impact the market. Novel ideas could significantly increase the size of an existing market, the rate at which that market might grow, or both. Start-ups originating from novel ideas could also create first-mover advantages, such as by erecting barriers to entry for competitors or tightly controlling necessary resources. A first mover might also earn better multiples (of value) as the leader of a category upon IPO or exit by sale of the company. In any case, the bigger the market, the better the potential opportunity.

Product Domain and Focus

According to Joshi, HV's core interests were in companies that were "building natively or uniquely mobile solutions to problems." Mobile development operated in a global economy, where there were almost no geographical barriers to competition. It was a complex, fast-paced, and challenging environment. HV knew this and expected start-up entrepreneurs to know this as well. The HV partners expected that any new mobile-oriented company should drive change and innovation in this space as well as create value. The partners wanted to know if the nascent product or service could offer something new, desirable, and compelling to the market, and if so, if this was something that consumers or companies would be willing to pay for.

Part of the HV team's investment thesis was to identify frontier opportunities in verticals they believed were particularly attractive. They also looked to see where they could bring their expertise to bear, such as in hardware leveraging SaaS models and e-commerce using gamification. Fundamentally, HV was looking for ways to participate in a growing technology market and to learn from these opportunities.

Since a large number of start-ups that wanted to work with HV were application (app) based, performance metrics were important. These metrics included, for example, assessing how many daily, weekly, and monthly active users engaged with the app; the cost to acquire a customer (i.e., how much was being spent to gain customers); and the projected lifetime value of the customer. HV would consider whether a customer's life cycle was being tracked and how long the customer payback period was (i.e., were there financial liquidity issues?). HV was also interested in cohort data, where groups of users from different intervals were tracked; for example, a group of users might be tracked for 12 months, and then, while this group continued to be tracked, a newly recruited group of users would also be tracked. The data would consider the difference between these cohorts. HV would consider whether the start-up was learning anything from these groups and whether the product was "sticky" with different users.

Defensibility

Start-ups that pitched to HV also had to demonstrate that their core thesis (e.g., product or service, strategy, and business model) was defensible. Defensibility came in different forms but could refer to a "moat" that prevented other players from competing effectively. A moat—an analogy to the deep ditches that formed a medieval castle's first line of defence—was something that limited a competitor's effectiveness in the marketplace. One kind of moat involved network effects, where the experience of any additional user was enhanced by larger numbers of users also in the network (e.g., social networking sites like Facebook and Instagram). Data network effects existed when the system could collect proprietary data (e.g., user information and activity) that enabled better predictions for improving and monetizing the system. Switching costs were another kind of defence. If the product or service was thoroughly integrated into a

customer's existing workflow, it became very difficult for the customer to switch or replace the service or product with one provided by a competitor.

Another key to defensibility came from competitive advantage. Competitive advantage referred to some element of the company's business that put it in a favourable business position—in Joshi's words, something that would "allow it to accelerate away from the competition should another player enter at some point." For example, Starbucks sold coffee that was relatively similar to others' coffee, but Starbucks' advantage was its customer experience (e.g., consistency and atmosphere). Walmart Inc.'s competitive advantage was its pricing: few companies could sell the same vast selection of products that Walmart did at the same low prices.

Vision

A key consideration that tied these opportunity elements together was the company's vision. HV was looking for start-ups with big vision—desire, perseverance, and relentless focus from the teams to build something massive. This tied closely with the potential market size. Joshi and the partners were not interested in firms with just modest growth in mind; they wanted firms with potential to reach the size of Google LLC or Facebook Inc.. As Joshi said, "We want to fund companies aiming to put a dent in the universe."

Analyzing the Team

In addition to the nature of the opportunity, HV carefully considered the team behind the start-up. Indeed, the team was perhaps the most important of all the facets of a decision to invest. For HV, it was important to believe not just in one or two of the founders, but in the entire start-up team. HV was looking for a team of winners—individuals who were passionate, competent, and aligned with the opportunity. Growth orientation and delivering on the potential of the opportunity "had to be in the team's DNA," Joshi remarked.

HV subscribed to the notion that a start-up team required a *hacker*, a *hustler*, and sometimes a *designer*.⁷ Generally speaking, the hacker had the knowledge and expertise to create the core technology as well as make the technical decisions for the start-up to sustain growth. The hustler was the business visionary and leader, managing the growing company and convincing investors of the short- and long-term vision of the company. The designer built the brand, user experience, messaging, and marketing.

The team was absolutely critical in HV's assessment of a prospective start-up. "A founding team's ability to attract great talent and augment themselves was a great signal of their ability to scale the company," Joshi noted.

Deep Diligence

Once HV conducted an initial analysis of the opportunity and team, the team would spend time engaging in what they called "deep diligence." This was an extensive and deep analysis of the different aspects of the start-up to thoroughly evaluate the prospective investment that investors might be making. To complement HV partners' own knowledge and expertise, the deep diligence process included finding additional subject matter experts to help the team better learn and understand the opportunity. The team might seek additional insight and expertise by tapping their network of limited partners, investors, entrepreneurs, and technical experts. The

⁷ "Hacker, Hustler and Designer: Building the Tech Team," MaRS, August 20, 2013, accessed October 17, 2018, www.marsdd.com/news-and-insights/hacker-hustler-and-designer-building-the-tech-team.

team would also likely do “soft” background checks on the start-up team. For example, they would try to find and speak with many of the people the start-up team interacted with professionally.

Although, ideally, there would be ample time to do this deep diligence, sometimes a timeline could be compressed into as little as a week. The partners needed to find a balance between acting quickly on an opportunity and not rushing and being pressured into making a decision. A syndicate of investors could often help to more fully evaluate the deal.

A Symbiotic Deal

While HV was ultimately an investor looking to make a return on its investment, it also cared a great deal about crafting a symbiotic or mutually beneficial arrangement for the entrepreneurs. The HV team considered themselves “operator friendly” and had a tremendous respect for entrepreneurs.

Value Add

The partners were serious about making sure they added value to the deal. “If you’re going to spend time doing this, you need to believe you are going to be able to meaningfully help the company succeed,” Joshi said. HV did not want to be “dumb money” or raw capital sourced from uninformed, uninvolved, and unengaged investors. Joshi and the partners looked for alignment with the founders to create a mentoring relationship. They fully acknowledged, however, that the partners were not going to be right all the time. It was more about sharing a common vision for the start-up and empowering the entrepreneurs.

Like most VCs, one of the biggest added values that HV could bring to a start-up was its extensive network of contacts. VC networks were all about creating leverage for portfolio start-ups in specific verticals. Business development, for example, could help introduce start-ups to customers and help build the rapport start-ups needed to grow their business. Networks could help bring in the right talent by making referrals and by actively searching for matching skill sets and experience that start-ups needed to strengthen their companies. A VC’s network could also help by providing access to capital, making introductions, and developing relationships among other investors to help benchmark the next layer of capital the start-up would need for its next steps.

Deal Structure

HV’s seed-stage investments typically ranged from \$500,000 to \$1 million in exchange for a variable amount of equity in the companies; this typically ranged between 10 per cent and 15 per cent ownership. HV typically anticipated a seven- to 10-year commitment from the entrepreneurs, so it was particularly important that HV strike a balance between the amount of equity it acquired and the amount it left with the founding team to ensure the founding team retained enough ownership to remain motivated and engaged. HV also wanted to be sure that the founders were rewarded at the end, in whatever form that might take (e.g., exit by sale or IPO).

HV generally secured its investment in a company through preferred shares or a convertible note. Preferred shares were a type of ownership stock in the company that had a higher claim on assets and earnings than common stock. Convertible notes were a kind of short-term loan to the company, which automatically converted to shares of preferred stock, typically at the close of Series A financing. However, convertible

notes generally had specific negotiated terms that were discussed when they were issued. Convertible notes could help to defer the potentially complicated valuation of a company until later in the start-up's life.

Another consideration of the deal that HV focused on was having a seat on the start-up company's board of directors. The board provided corporate governance and oversight of the company and was typically composed of experienced leaders who knew and understood the company's business domain. HV's perspective was that, at the seed stage, the founders should be in control, but HV typically requested a seat on the board to help shepherd the company.

CONCLUSION

Joshi knew that it was going to be a busy day today. It was typical for him to meet with three companies per day, including those he was supporting and those that were interested in investment. So many different things in this job were competing for his time. On his way out the door, Joshi glanced at HV's portfolio wall, which displayed plaques showing the logos of each of the 28 firms HV had invested in. Joshi knew that he and the other partners at HV had a reasonable evaluation system operating in an environment of hungry, enthusiastic start-ups that was only getting larger and more diverse every year.

While HV had certainly experienced some success over the last few years, being a VC was not getting easier. It was a constant challenge to stay apprised of the changing technology landscape. Methods and practices that had worked in the past were not guaranteed to work in the future, and competition—both for the selection of good investments and for start-up success—was only getting fiercer. Was HV making the right investment choices? Did its selection process need to evolve and if, so how? What was the best way to stay on top of so many moving parts? Despite these lingering questions, Joshi and the partners at HV knew there was no other job they would rather be doing: VC investing was simultaneously challenging and thrilling.