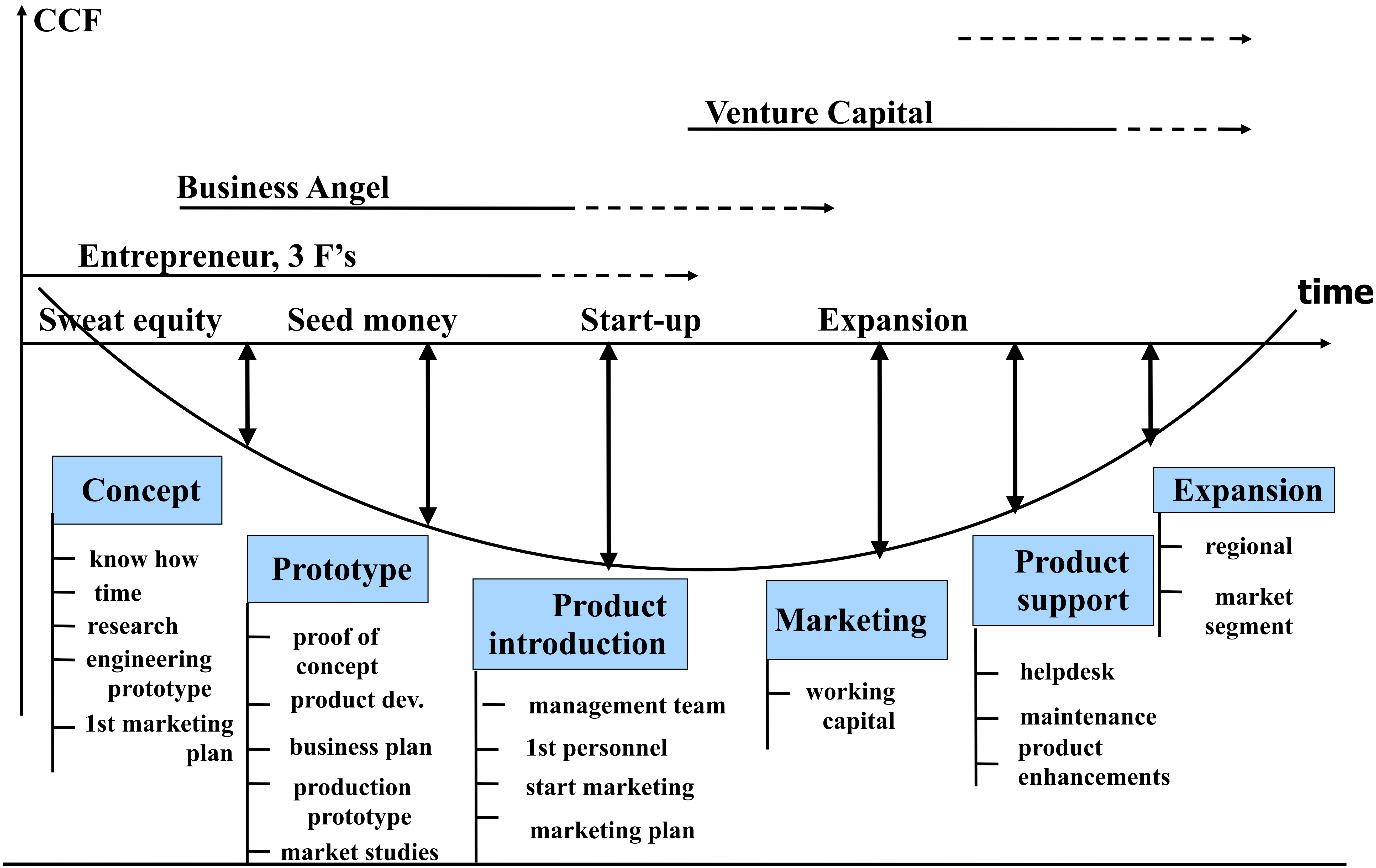
Funding startups

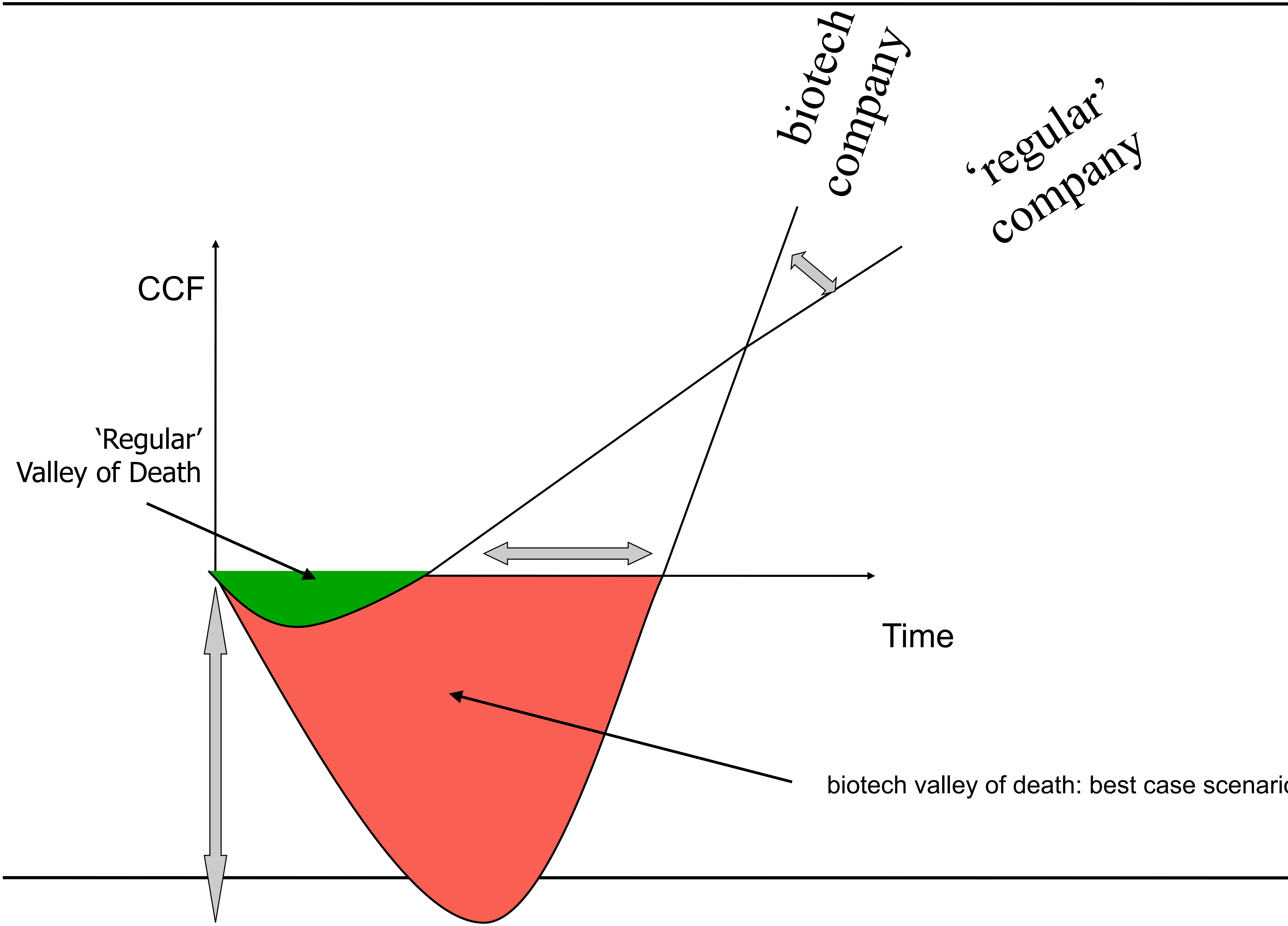
Marc Goldchstein

funding growth



Source: Rudy Aernoudt (adapted BAN-V)

biotech and finance



Conclusions

- Many companies require capital to fund their startup
- Size of the needs depends on many factors
  - Often related to the 'business model' of your project: Service company? Technology developer? Investment goods supplier? Component supplier? Economies of scale?
  - What enabling technology? What end-user industry? Pace of change in industry?
- There are several potential sources for this funding
  - Your own resources
  - 3F's: friends, family and fools
  - banks
  - partners
  - customers and suppliers
  - venture capital and business angels
  - Stock exchange (IPO)
  - + crowdfunding
- Each have their properties, pro's and con's

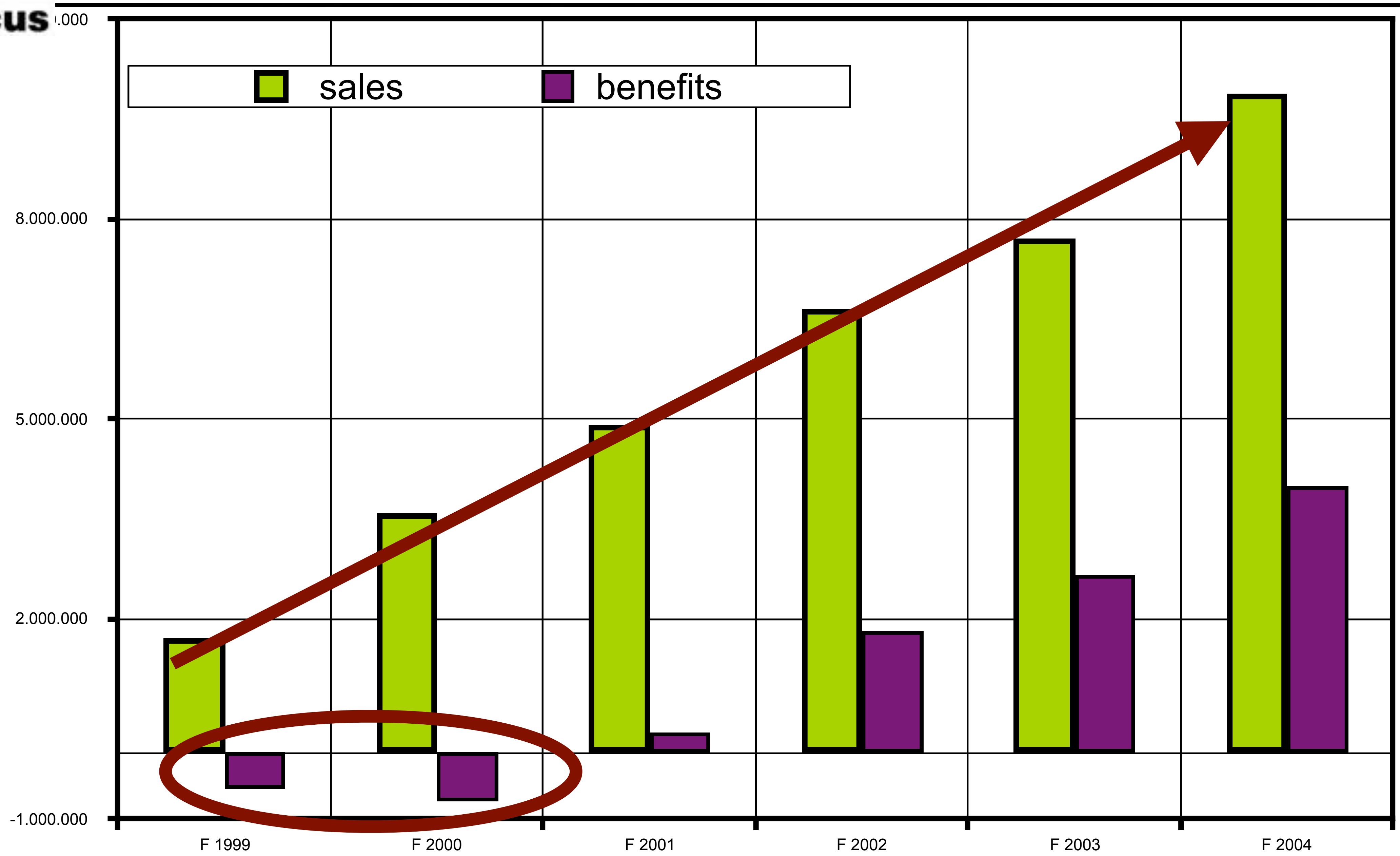
Risk capital

Informal risk capital

- Own resources and time
  - Each entrepreneur invests his own time and often money
  - Belgium: 90% of startups use own capital of entrepreneur; often pays himself small or no wage in startup period
- Friends, family and fools
  - can be source of funds
  - be aware of disadvantages:
    - risking personal relationships
    - inexperience of investors

Venture Capital

what it's all about...



- Enfocus software 1998
- 1 million Euro in venture capital for 28% of company
- To fund expansions plans
- Shares sold for +/- double the amount one year later

Venture Capital

- Venture capital (VC) is financial capital provided to early-stage, high-potential, high risk, growth oriented companies.
- the companies usually (but not necessarily) have a novel technology or business model in high technology industries, such as biotechnology, IT, materials, etc.
- The venture capital fund receives equity (aandelen) in exchange for the monies invested in the company
- The typical venture capital investment occurs after the seed funding round as growth funding round (also referred to as Series A round)
- The VC generates a return by selling the shares it owns in an IPO (initial public offering, beursgang) or trade sale of the company.
- Venture capital is a subset of private equity. Therefore, all venture capital is private equity, but not all private equity is venture capital.
  - Based on Wikipedia
- Risk sharing investment money
- With limited investment time horizon
- Supplied by professional investors
- In growth oriented companies
- In form of shares of company

Not for everybody...

Tabel 7 Kapitaalbronnen: gemiddeld aandeel (volgens innovatieactiviteit)

	Alle starters	Niet-innovatieactief	Innovatieactief
Eigen middelen	73.1	71.7	74.1
Banklening op naam van de oprichter(s)	4.9	6.4	3.7
Familie	2.9	3.5	2.5
Vrienden	0.5	0.6	0.5
Business angel	0.1	0.0	0.2
Venture capital	0.9	0.5	1.2
Overheid	0.2	0.2	0.2
Banklening op naam van de vennootschap	15.3	13.2	16.3
Andere bronnen	2.1	3.0	1.7
Totaal	100	100	100

Bron: START bestand 2003 (N=565).

- START database
  - Flemish enterprises (vennootschappen)
  - between one and two years old
  - employing 50 or less people
  - representative population of 637 enterprises was selected and queried.

some statistics

The Venture Capitalist

the financial logic of a VC

quality of investment	bad	alive	ok	good	super	total
amount invested	200	400	200	100	100	1000
Multiple after 5 years	0	x1	x5	x10	x20	
Cash from trade sale	0	400	1000	1000	2000	4400
Revenue	-200	0	800	900	1900	3400

- (Peter Camps)

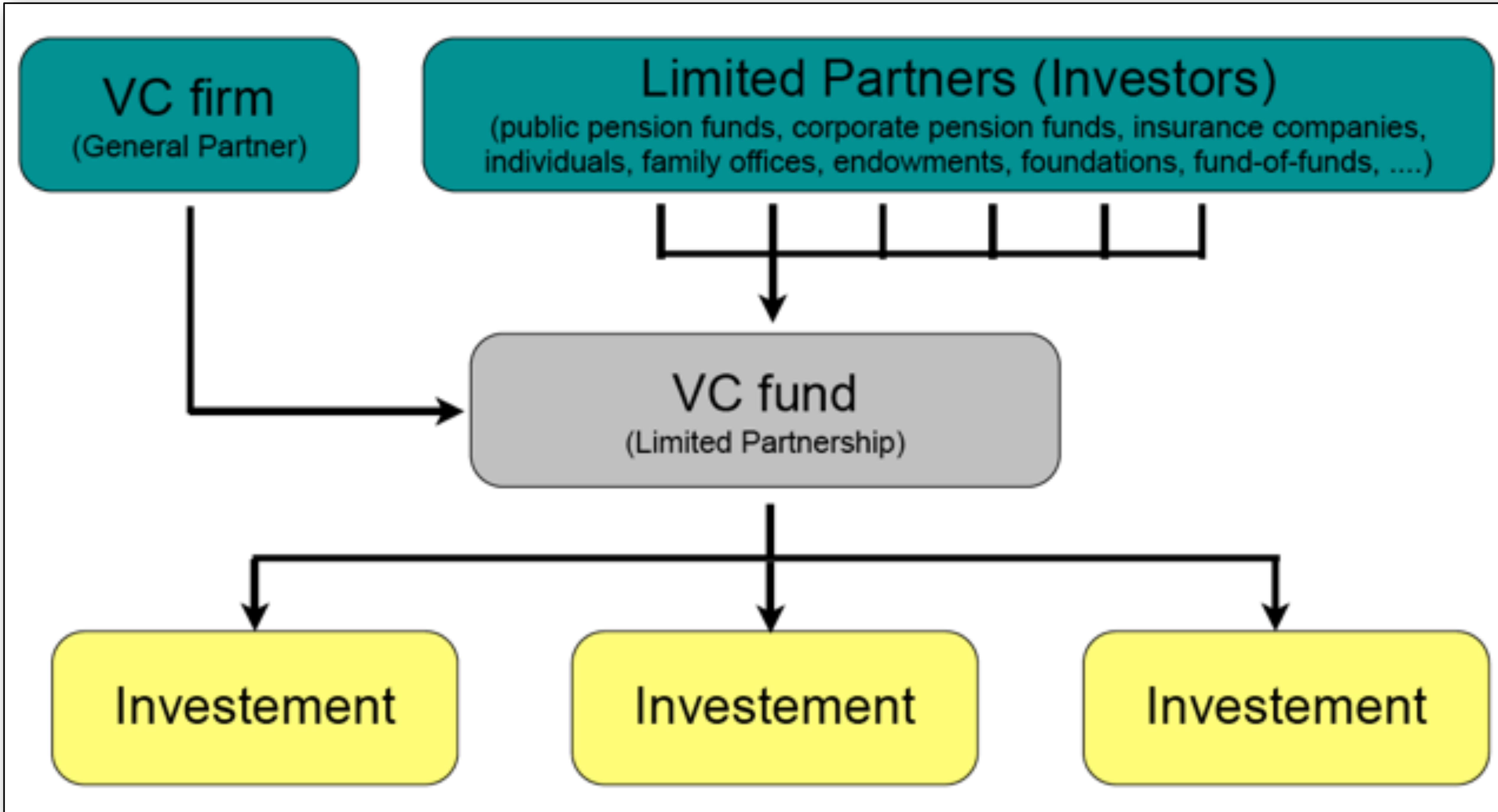
- VC's look for companies that have the potential to score really big, to compensate for the total failures
  - sometimes it feels like VC's want to be lied to.
  - I've never over-promised, I've always presented what I believed was realistic – or even conservative.
  - but it's important to show the long-term upside potential,
  - so you end up with a two-pronged business plan

Different VC leagues

- Friends, Family and Fools (3F's)
  - Pre-seed financing
  - Smal(ler) amounts, single investment
- Business Angel (BA)
  - Seed/ start-up financing
  - Relatively small amounts, limited investments
  - Active monitoring and assistance
- Venture Capitalist (VC)
  - Seed/ start-up/ expansion financing
  - Bigger amounts, larger portfolio of investments
  - Also 'hands on' financing, but due to portfolio size, less than BA
- Private Equity (PE)
  - Turnaround financing, leveraged buyouts
  - Large scale projects (consolidation of industry players,...)
  - Very big amounts
  - Little hands-on, but mainly financial architects
  - Often commitment to firm limited in time (exit)
  - Examples: Health City

– + Crowdfunding: see later

The Venture Capitalist...



Some terms

- Funding stages
  - Pre-seed
    - Mostly just an idea about the business concept
    - No product yet
    - Technological uncertainty
  - Seed
    - Business concept is fine-tuned
    - Proof of concept delivered
    - Prototype might be delivered as well
  - Early stage/ start-up
    - Proof of product
    - Company starts up, makes first real marketing expenses
  - Growth/ expansion
    - Proof of market
    - Company expans and turns break-even

- Investment rounds
  - VC's do not invest all the money required to get to profitability in one go
  - Often the 'necessary' funds are provided to achieve certain milestones
  - Round A, Round B...
- Lead investors and others
  - Often one investor does the work: due dilligence,...
  - Often (a) new investor(s) join in the following rounds, and they become lead investor

How VCs decide...

- Most VC's focus on a certain subset
  - such as
    - industry sector (biotech, IT, energy, materials...)
    - investment size
    - stage of investment (early stage capital, ..)
    - geographical focus
  - this functions as a filter for VC's
  - It enables them to provide 'smart money': allows them to leverage their expertise and networks within a certain domain
- Two schools of thought:
  - ' I invest in people first and foremost. Smart people will find great opportunities and I will never know the sectors or technologies as well as smart people.'
  - 'I don't care about people, I care about markets. I look for big painful problems that customers have. If management doesn't work out, I can always fix management.'

- Typical Venture Capitalist profiles
  - technology investors
    - focus on uniqueness and protection of product and technology, then on close personal contact with entrepreneur
    - investment manager has technical expertise, sometimes ex-entrepreneurs
    - often government funded, local focus
  - people investors
    - leadership, team, then financial
    - mainly private investors, both early stage and follow up investments
    - non technological as well as technological
  - financial investors
    - 30% of sample
    - financial return from BP is essential, then team
    - Often funds related to banks
- Other considerations
  - Fund duration
  - Portfolio balancing
  - Recent experiences
  - Personal preferences: distance,...

QBIC

- The Qbic Fund is a multi-sector fund supporting spin-off companies of the Ghent, Brussels and Antwerp university associations and of VITO. Through its strategic partnership the Qbic Fund has early and privileged access to promising research projects at these partner universities.
- Currently it has over € 30 million under management. The Qbic Fund is backed by several public and private investors and managed by Qbic Venture Partners.
- Our investment strategy comprises two core categories:
  - A university spin-off, i.e. a company that was founded to offer products or services based on academic technological innovations originating at the universities of Ghent, Brussels and Antwerp and their associations.
  - A university linked start-up, i.e. a company whose products or services rely significantly on academic technological innovations originating at the universities of Ghent, Brussels and Antwerp and their associations.
- Qbic Fund emphasizes investment opportunities in the fields of life sciences, new materials and ICT projects and is particularly interested in multidisciplinary approaches. The fund size allows for follow-up investments.

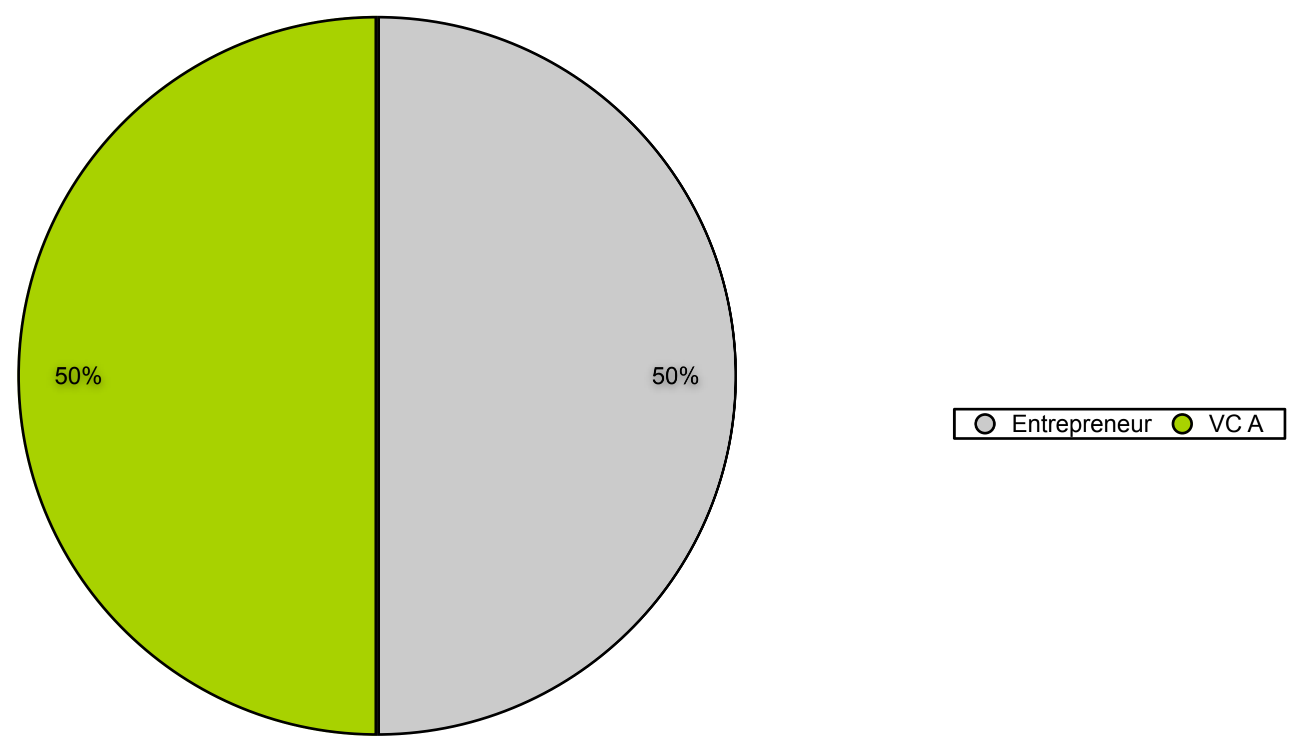
Central issue: dilution

dilution

- key term and possible pitfall
- a reduction of the share of common stock that occurs through the issuance of additional shares

example

- situation after first investment round:
  - entrepreneur: 50% of shares
  - VC A: 50% of shares for €3 million
  - so, the company is valued at €6 million

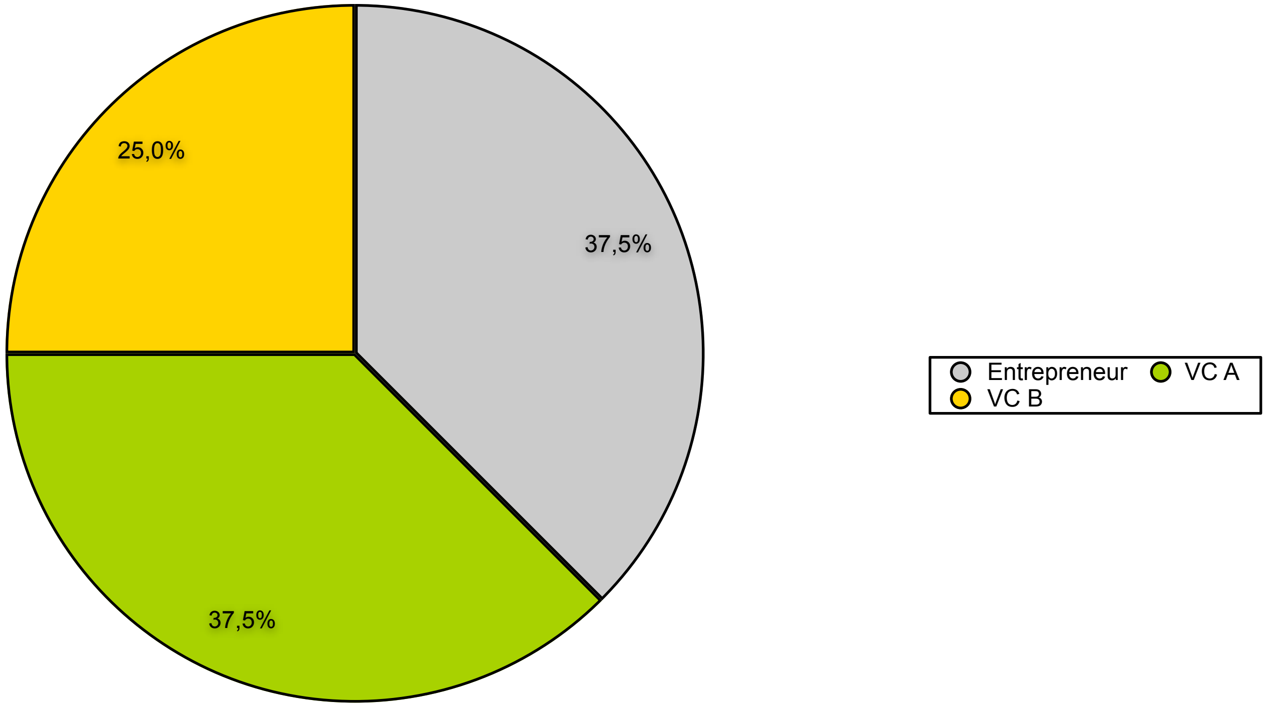


example

- in the next financing round, an extra investor is attracted: he will invest €3 million in return for 25% of the shares (new issues). assume that investor "VC A" and the entrepreneur will not participate in this second financing round.
- what will happen?

example: dilution

- new situation:
  - the company is valued at €12 million
  - if the dilution is shared equally by the entrepreneur and VC A, the new shareholder structure becomes:
    - entrepreneur 37,5%
    - VC A: 37,5%
    - VC B: 25%



dilution

- what can a VC or an entrepreneur do in order to prevent dilution?
  - put money on the table (follow-on financing)
  - negotiate when investing: clauses, share classes…
  - …

valuation

INTERNATIONAL PRIVATE EQUITY AND
VENTURE CAPITAL VALUATION GUIDELINES

These guidelines have been developed by the Association Française des Investisseurs en Capital (AFIC), the British Venture Capital Association (BVCA) and the European Private Equity and Venture Capital Association (EVCA) with the valuable input and endorsement of the following associations:

AIFI, Italy - APCRI, Portugal - APEA, Arab countries - ASCRI, Spain - ATIC, Tunisia - AVCA, Africa
AVCAL, Australia - AVCO, Austria - BVA, Belgium - BVK, Germany - CVCA, Canada - CVCA, Czech Republic
DVCA, Denmark - FVCA, Finland - HKVCA, Hong Kong - HVCA, Hungary - ILPA - IVCA, Ireland - LVCA, Latvia
NVCA, Norway - NVP, The Netherlands - PPEA, Poland - Réseau Capital, Quebec - RVCA, Russia
SAVCA, South Africa - SECA, Switzerland - SLOVCA, Slovakia

(Endorsement as of 1st of November 2005)

Le capital investissement

BVCA investing in enterprise

METHODOLOGY
Price of Recent Investment
Earnings multiple
Net assets
Discounted cash flows or earnings (of Underlying Business)
Discounted cash flows (from the Investment)
Industry valuation benchmarks

valuation: why?

- business valuation: to determine the fair market value of an owner's interest in a business
- reasons for business valuation
  - external
    - investors need to find out wether or not they should participate in a company
    - entrepreneurs need to know what share they are willing to sell in exchange for the additional money
  - internal
    - capital allocation
    - investment decisions
    - M&A
    - during licence negotiations
- By definition uncertain value:
  - High risk, long time horizon, market conditions...
- Valuation calculations
  - return expected by VC
  - expected profits of company in # years
    - validity of prediction
  - value of the company, based on its profits, on P/E ratio
  - Market value
- Much depends on
  - situation of market and economy
  - negotiation position
  - "there is no gold standard when it comes to valuation: it is and will remain a subjective task. Consequently, a company can have as many values as there are people doing the valuation." (Frei & Leleux, 2004)

valuation techniques

- discounted cash flow valuation (DCF)
  - NPV
  - IRR
  - Risk Adjusted NPV
- relative valuation/comparables
- real option valuation
- added value
- -> see Advanced Starter Seminars

Due diligence

Due Diligence

- In the course of the process an in-depth study of your project will be performed
- Due diligence is the process by which confidential legal and financial information is exchanged, reviewed and appraised by the parties to a merger or substantial asset transfer.
- The essence is an effort to make everyone as aware as can be of any liabilities the other party may bring to the transaction.
- The desire is to create a "no surprises" situation.
- The potential investor generally uses in-house resources or hires a consulting firm

term sheets

Term sheet

- Document in which the conditions under which the VC invests in the company is defined
- Is translated in final contract between actors: shareholder agreement, side letters

Some things to watch out for...

- watch closely for clauses that undermine your control over the company
  - vc's often invest large sums of money in a startup company in return for a small percentage of the shares
  - it is therefore reasonable that they expect certain additional control rights, over and above the rights automatically attached to the percentage of shares they own
  - make sure you feel comfortable with these additional control rules, especially since all of this stuff is in fairly inaccessible legalize.
- watch closely for clauses that define procedures or restrictions for selling shares
  - vc's will demand certain limitations on selling shares. for example, they'll want a "sell along" clause, to ensure that you don't sell your 80% percent of the company to some bozo, leaving the vc's with basically worthless shares.
  - make sure you feel comfortable with these rules, and try to make them as symmetric as possible (e.g. providing other minority shareholders with the same rights as the vc's).
- watch closely for non-compete and commitment clauses
  - the vc will want to guarantee that the key company staff remains committed to the company for a certain period of time after the investment; a reasonable request
  - make sure you understand the implications of these extra "ties" to the company, and minimize the period
- don't run out of money before you get new funding
  - don't wait too long to start the process
  - don't ramp up your expenses until you have new funding secured
  - it is much easier to get money when you don't need it (yet)
    - people appreciate the fact that you have planned ahead
- never sign a personal guarantee, unless that's exactly what you want

  - (Peter Camps)

after you get the funding

- Peter Camps

- be prepared for a different mode of operation
  - the control rules and a formal board of directors require quite some time preparing for and running meetings
    - updating business plans, preparing investment requests, building argumentation pro/con potential business strategies, etc
- this is not all bad, since it forces you into a professional, structured mode of operation.
    - but it does take time and effort
    - it can be very frustrating to explain your business to someone who doesn't understand your business…
- watch for "political" reasons behind certain standpoints
  - vc's invested in your company for their own reasons
  - their risk assessment may differ from yours
  - attempt to get these issues out on the table, rather than lurking in the corner as a hidden agenda.

2.3 Exits

Exits

- Because:
  - VC’s invest in a company for a limited time
  - They want their money back after that period
- VC’s exit by selling their shares to someone else...
  - Generally the whole company is sold to another company
  - Sometimes the company goes to the stock exchange and they sell their shares
- Working with VCs implies accepting the fact that you will probably sell your company...
- ...They will check whether you fully acknowledge this
- The attitude may be different with industrial investors and some private equity funds

IPO: initial public offering

- description: sell the shares of the company to the public to be traded on a stock exchange
- advantages:
  - conversion to cash for investors
  - majority shareholders usually maintain control
  - high potential return
- disadvantages:
  - company must have tremendous growth potential to for an IPO
  - costly process
  - uncertain outcome
  - major shareholders may be limited as to how much, when, and how they can sell stock
- example: Ablynx 85 million fresh cash in company

Trade sale

- Business bought outright by another existing company
- Advantages:
    - Investors and entrepreneurs receive cash (or stock)
    - Often purchased by strategic partner with important complementary assets
    - Management contract can be negotiated
- Disadvantages:
    - Fit must be appropriate
    - Potential management changes
    - Corporate identity may disappear

frequency of exit routes

AN EMPIRICAL ANALYSIS OF VENTURE CAPITAL EXITS IN EUROPE AND IN THE UNITED STATES *

Armin Schwienbacher †
Univ. of California at Berkeley and Univ. of Namur

April 2002

– http://www.rotman.utoronto.ca/cmi/news/schwienbacher.pdf

Table 2: Frequency of the Different Exit Routes (Average Track Record)

Exit Route	Already accomplished exits (until 2001)		Planned (in 2001) within two years	
	Europe	US	Europe	US
IPO (+ Sale of Quoted Equity):	25.3 %	29.9 %	34.4 %	36.2 %
Trade Sale / Acquisition:	38.4 %	30.3 %	47.2 %	36.3 %
Management Buyout:	6.3 %	2.0 %	3.6 %	0.8 %
Secondary Sale / Refinancing:	9.2 %	5.0 %	4.9 %	6.7 %
Liquidation (Write-Off):	20.8 %	32.8 %	10.0 %	20.0 %