Financing Emerging Growth Companies

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School of Business

July 8, 2005

- 1:00 – 1:50 Class overview, review syllabus, grading, case studies
- 2:00 – 2:50 Life-cycle of a business & stages of financing
- 3:00 – 3:50 Fund-raising process; finding investors; term sheet
- 4:00 – 5:00 Assign & discuss first case

Overview

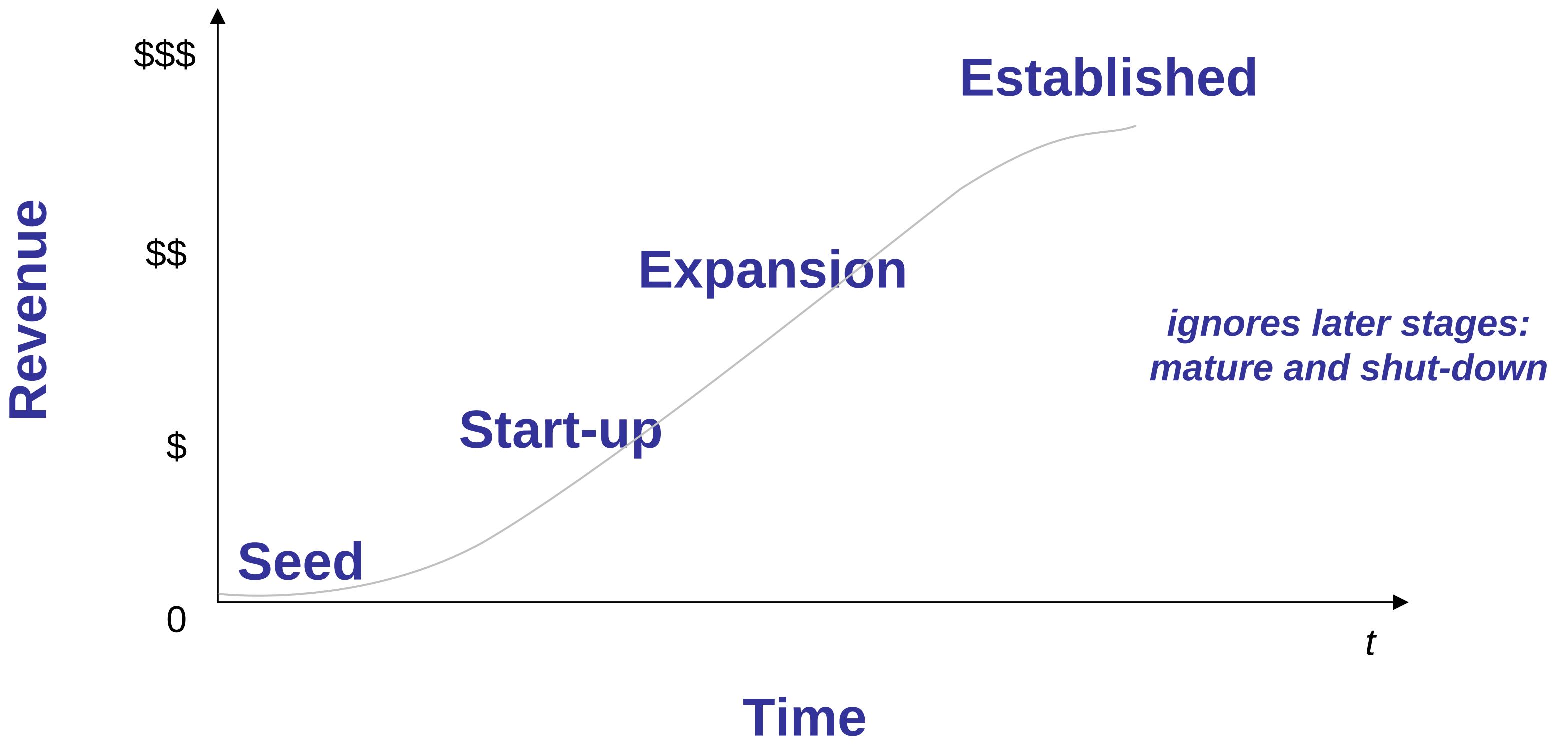
- Focus for funding sources
- Business lifecycle overview
- How much money is needed
- Sources of funding
  - Angel investors
  - Venture Capital
  - Strategic Investors
  - Venture Banks
- Building value

Funding Sources

- Federal government
- State government
- University programs
- Private foundations
- Angels
- Venture capitalists
- Strategic investors
- Banks
- Suppliers
- and many others...

Our Focus

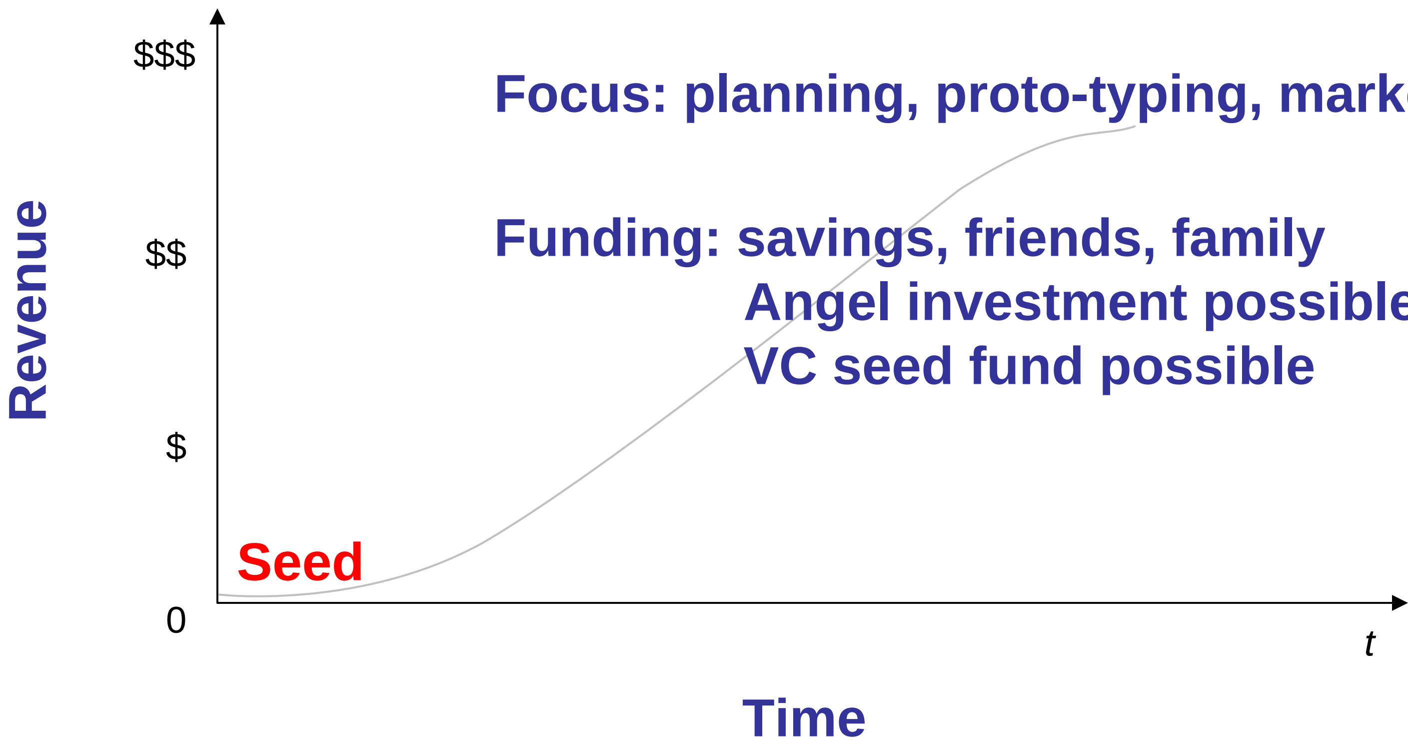
Business Lifecycle



Business Lifecycle

Focus: planning, proto-typing, market testing

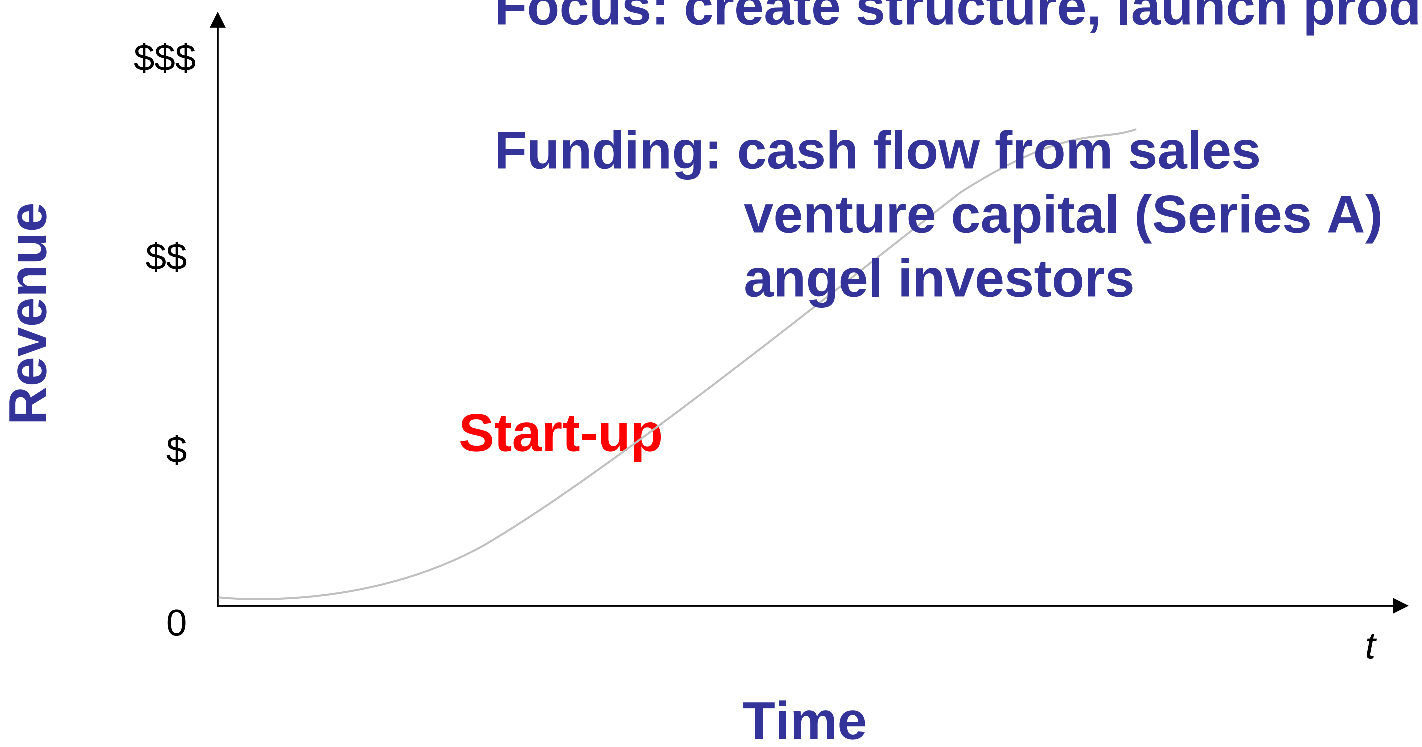
Funding: savings, friends, family
Angel investment possible
VC seed fund possible



Business Lifecycle

Focus: create structure, launch product

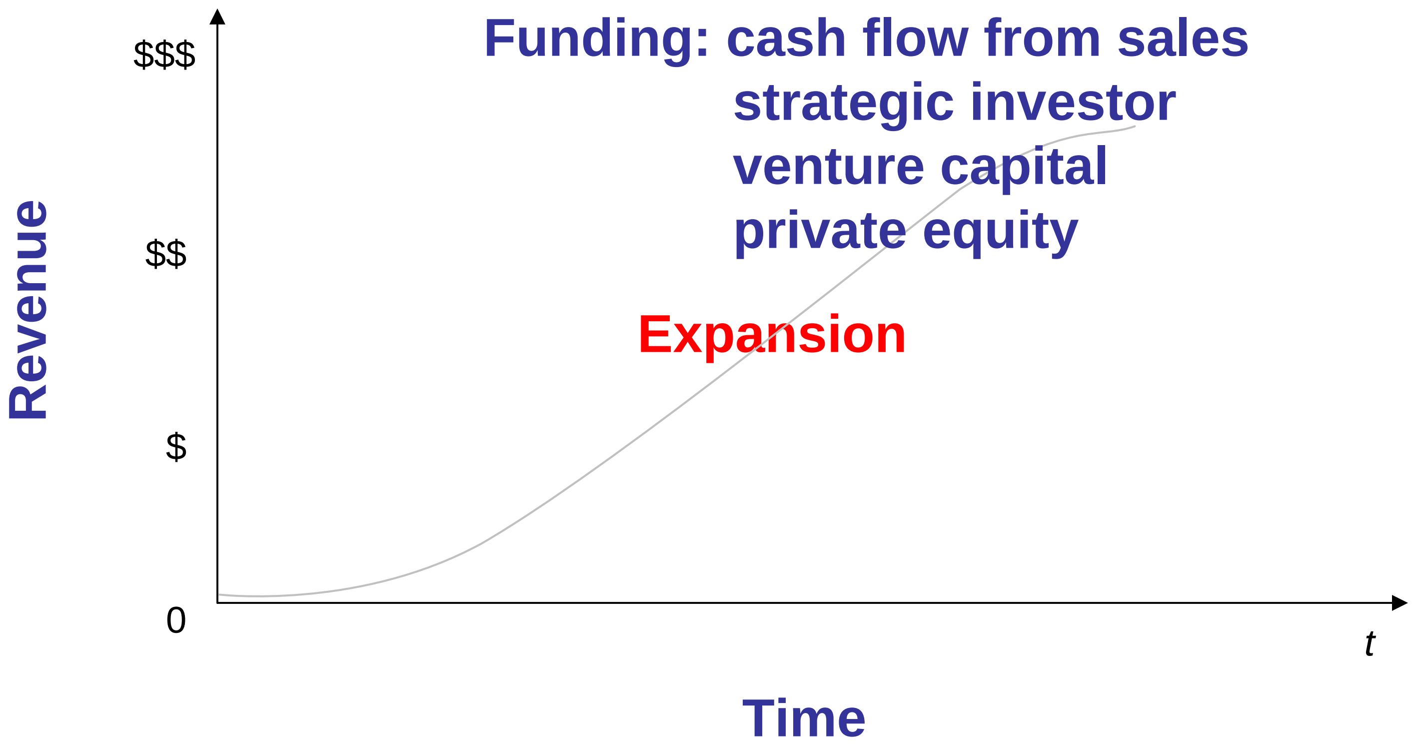
Funding: cash flow from sales
venture capital (Series A)
angel investors



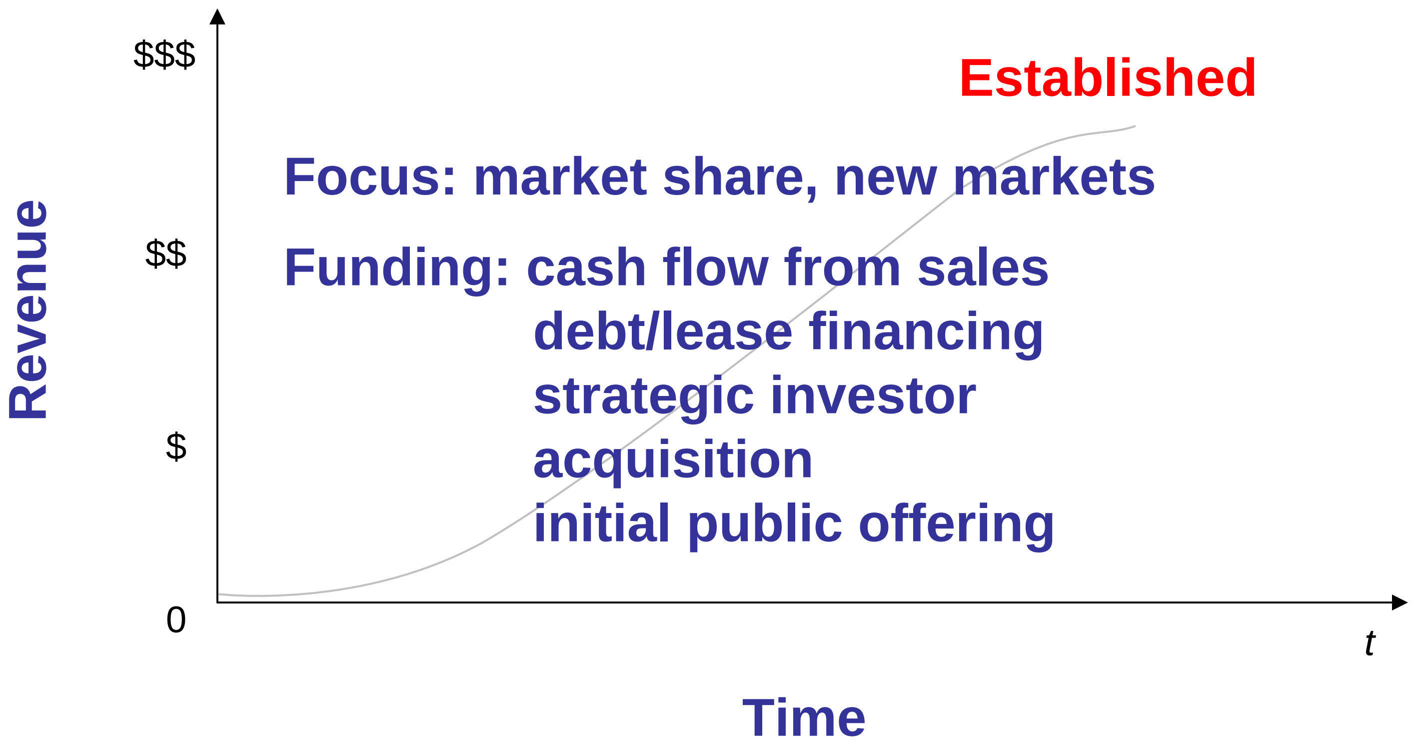
Business Lifecycle

Focus: grow sales

Funding: cash flow from sales
strategic investor
venture capital
private equity



Business Lifecycle

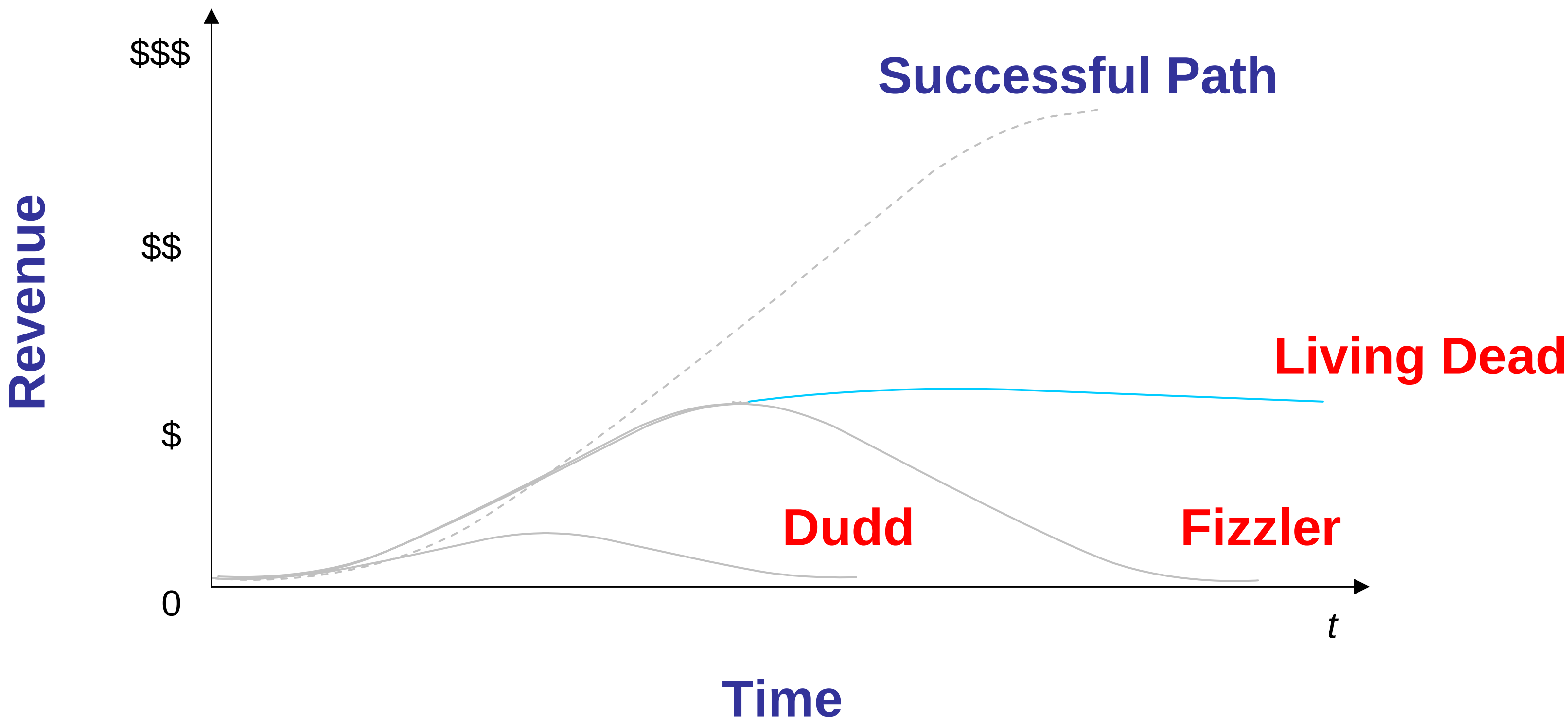


Focus: market share, new markets

Funding: cash flow from sales
debt/lease financing
strategic investor
acquisition
initial public offering

Business Lifecycle

Not All Are Successful



How much money is needed?

- Most companies subsist using <u>internally generated cash flows</u> – profit made by selling goods and services.
- Tech startups must “invest” in technical and product development before any sales can occur – outside money is a subsidization. (Catch-22)
- Once a tech startup has developed a commercial product, sales can begin. But what about paying for salespersons, manufacturing, advertisements, etc?
- Outside money is again used to subsidized a faster growth rate.

How much money is needed?

- In determining how much money is needed, set goals and work backwards. Establish money needs for a particular “phase” or time period (each 6 months).
  - Money needed to develop prototype (development phase)
  - Money needed to fund salespersons/ads for 6 months
- Recall alignment: product development, marketing, operations, finance (what it costs to meet goals?)
- Companies that seek outside funds to support activities in furtherance of goals are more successful.

Angel Investors

- Wealthy individuals who make very high risk investments.
- Generally smaller investments to help support prototype development. Believe in viability of technology.
- Some angels seek to join firm as executives and/or board members.
- $25K-$250K common investment amounts; easier to obtain if supplementing grants.
- Valuation and ownership % rarely complex – typically angels receive 10%-15% of company, dilution OK

Angel Networks

- Angel networks are simply groups of angels that invest together and hire a single individual for sourcing and screening.
- Capital Investors Network, Dinner Club, Private Investors Network
- How to find angels? Professors, personal contacts (e.g. lawyers, accountants).
- Angels want to invest in tech startups! For a wealthy individual, $25K investment not so risky.
- Angels can be very helpful: recruiting execs, find VCs down the road, identify customers, etc.

Venture Capital

- 98% of successful US startups receive $0 in VC.
- Of companies that do receive VC $, success rate is about 30%.
- VC companies are huge risk/huge reward deals. Hence, VCs want to invest in companies that generate high growth rates in short time periods.
- The basic formula: A VC invests $5 million; firm wants $25 million returned w/in 5 years. VCs typically own <25% of the company at 5-year anniversary.
- VCs want an exit w/in est. 5 years: IPO or sale

Venture Capital

- If VC owns 20% and stake valued at $25 million in 5 years, company worth a total of $125 million!
- If company worth $125 million, earnings likely approximately $10-$15 million (8-12 times earnings).
- If earnings estimated $12.5 million, revenues likely about $80 million (15% profit margin).
- SO, can you convince a VC that your firm will likely generate $80 million in revenues five years following the $5 million investment? Very tough.

Venture Capital

- How do you convince a VC firm your innovation can generate an $80 million business in five years, assuming you need $5 million in money from sources <u>other than</u> grants, state funds, etc?
  - Large or growing market
  - Technology differentiated – will capture customers; customers will remain loyal
  - Technology protected
  - Great marketing/sales plan: aggressive!
  - Well-thought-out operating plan/scale up plan
  - Experienced management (VC can help here)

Venture Capital

- VC firms fall into categories.
  - Stage of investment
  - Industry
  - Geography
- Early-stage, middle-stage, pre-IPO, late-stage expansion: later stage = lower risk; why?
- IT broad, biotech specific, telecom specific, software specific; some broad and some narrow
- Geography: some require “2-hour” rule and others do not; CA, Mid-Atlantic, Boston, CO, NY, TX major geographic concentrations

Venture Capital

- VC $ is only a subsidy to accelerate growth; without VC money it might take 3 years to develop a product; with VC money it might take 6 months!
- Reporting to VC board members can be tough.
- In selecting a VC, consider contacts, industry experience, amount of funds, recent deals.
- The further along a company is on the continuum of product development and customer sales, the easier VC $ is to obtain.

Venture Capital

- VC deals can be structured creatively:
  - Straight equity investments
  - Convertible debt transactions (with VCs and/or angels)
- Leading VC firms:
  - New Enterprise Associates
  - KPCB
  - Benchmark
  - Summit
  - Texas Pacific Group
  - Draper Fisher Jurvetson
  - Venrock
  - 3i
  - National Venture Capital Association Web site
- Other VCs: corporate, law firms, consulting firms

Strategic Investors

- Larger companies in your industry want access to emerging technologies for their own product lines, as component suppliers, and/or as customers for their products/services.
- Strategic investors have motivations beyond gaining a return on invested $$ - access to technology in some capacity.
- Strategic investment can run the gambit from $100K upfront (no strings attached) to $20 million investments from firms like GE, Cisco, Dell, etc.
- Once you “get in bed” with a strategic investor, your neutrality is sacrificed. Make sure it’s worth it!

Strategic Investors

- Some leading strategic investors:
  - GE
  - United Technologies
  - Northrop Grumman
  - Cisco
  - Microsoft
  - Dell
  - Sun Microsystems
  - Hitachi
  - Fujitsu
  - and many more...
- Available world-wide

Venture Banks

- Once you have customers, you can often borrow from a bank for expansion.
- Short-term debt (90-180 days) secured by accounts receivable (monies owed by customers).
- Longer-term debt (up to 10 years) secured by inventory, assets of company, guarantees.
- SBA loans: for early-stage and/or small companies SBA guarantees 75% of loan so collateral requirements reduced.
- Advantage of debt: once you're approved, it's easy to borrow. No 30 page applications!

Building Value

- You start a company valued at close to 0; over time the company grows in value. How? Why?
- The value of a company is calculated based upon (a) current profits; and/or (b) expected profits; and (c) profit growth rate (current or expected).
- High-growth companies valued at 20+/times profits. If profit is $1 million, valuation is $20 million; if profit grows 20%, value will grow to $24 million next year.
- For entrepreneurs (founders), tough decisions: retaining ownership for yourself or giving ownership to others (execs, investors).

Building Value

- Being a founder means taking risks: accept a smaller piece of the pie in exchange for the hope of a larger pie!
- Enhancers of value (in an IPO or sale of the company):
  - Protected IP (sustain competitive position over time)
  - Diversification of customers
  - Recurring revenues (customers can’t switch)
- Capitalizing on value:
  - IPO
  - Sale/merger

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Financing Process

- Begin first round
  - Business plan
  - Prospect list
  - Pitch plan
  - Term sheet
  - Due diligence
  - Closing documents
  - Funding
- Begin next round

Repeat

Business Plan

- Detailed business plan
  - Market/competitors
  - Sales & marketing
  - Product evolution
  - Operations
  - Financials (three years minimum)
  - The team
- Executive summary – *sales document*
- Investor pitch – *sales document*

Prospect List

- Market focus
- Type of funding
  - Personal
  - Institutional
  - Angel
- Geography
- Build list
  - Associations
  - Angel networks
  - Online resources
  - Brainstorming & networking

Pitch Plan

- Identify “lead” investor
- Create syndicate
- Sales process
  - Series of sales
  - Close phone interview
  - Close face-to-face
  - Close term sheet
- Anticipate objections
- Ask for referrals
- Be relentless

Term Sheet

- Capture terms of "the deal"
  - Ownership
    - Valuation
    - Pre-money
    - Post-money
  - Liquidation preference
  - Restricted stock
  - Anti-dilution
  - No shop
  - Other terms
- Ideal scenario: multiple offers
- Subject to "customary due diligence"

Due Diligence

- Detailed research
- Can take months
- Typical information (be prepared)
  - Background checks
  - Historical financials
  - Patents & trademarks
  - Incorporation documents
  - Capitalization tables
  - Customer references
- Be open & honest
- Be responsive

Closing Documents

- Purchase agreement
- Stock/warrant/security...
- Representations
- Securities filing

Funding

Show Me the Money

Start Next Round

- Don't wait until you need it
- Don't run out of money!!
  - Manage cash flow
  - Keep plan current
  - Provide 6+ months of cushion
  - Get cash flow positive
- Keep investors updated
- Identify lead
  - Outside lead (outside round)
  - Inside lead (inside round)
- Bridge financing