

DTU KU 2010 e'ship class

7. lecture, Tuesday 9 March 2010

Financing Technology Ventures

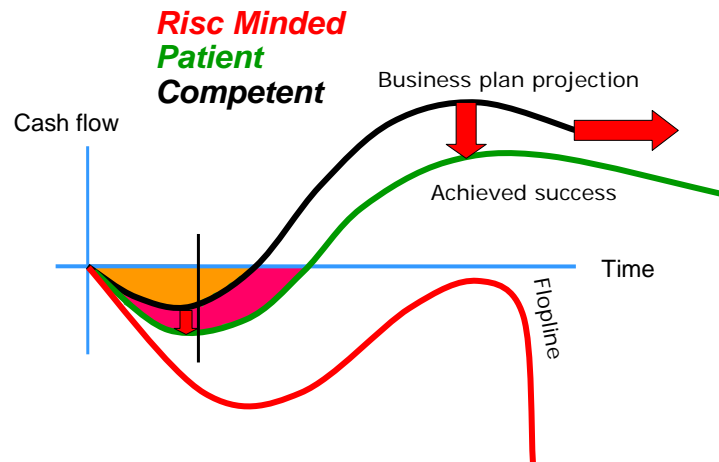
FINANCING Technology Ventures

Agenda

- ***Capital: for what ?***
- ***Capital: from where?***
- ***Capital types related to Business Development***
- ***Investor types***
- ***The Investor's Quality Criteria***
- ***Evaluation of Companies***
- ***Example***

Learning objectives: to enable you to identify your investment opportunities and to design your business model and your business plan to match these.

Capital: for what? *Business Development!*



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The entrepreneur's most important Capital Sources

- **Your own bloody money**
- **FFF** Family, Friends & Fools
- **In Kind** Other people's resources
- **Your first customer:** The more pain, the better
- **Investors' money** If your business potential and -opportunities depend on speed and volume.

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Origins of Capital

- **You make it unnecessary**
 - Live on a Rock
 - Start selling!
 - In kind
- **You have it:** Savings, personal fortune
- **You get it:** Grants
- **You borrow it:** Loan capital
- **You sell shares:** Share capital
private equity
equity capital

GRANTS

- **Public Industrial Development Programs**
- **Ministerial focus area**
- **Private Foundations**
- **Etc.!** See www.vf.dk

Comments:

- Dream-capital for start-ups
- Hard to find but it happens
- In EU: limit: 200.000 EUR in public grants
- Grants are taxable income, but expenditures are tax deductible.

LOAN CAPITAL

- **Banks**
- **Credit Institutions like FIH**
- **Private debt providers – the loaners**
- **Special products like Vækstkaution, Mezzanine capital etc.**

Comments:

- **Cheap for the entrepreneur – Expensive for the Company**
Paid back by the company. The entrepreneur preserves ownership
- **Personal collateral mandatory in the start-up phase.**
If business flops: repayment after personal tax. No tax-deduction!
- **Investor runs a business**
Never let this fact be overshadowed during the moments of joy and enthusiasm

LOAN CAPITAL - 2

The Convertible Loan

- **Normal interest and repayment profile**
- **Can be converted into share capital on specific conditions and at specific milestones**

Comments:

- **Some advantages in the start-up phase**
Less initial dilution of the founders.
Investor may convert to preserve ownership at new funding rounds.
- **Check the conditions**
Investor gets a strong handle bar on business development
Conversion right linked to milestone specifications. Eg.: conversion rate linked to quantified performance.

SHARE CAPITAL – private equity

Investor buys shares in the company

- **At kick-off with the founders**
- **Later: at capital increase (Funding rounds)**

Comments:

- **Expensive for the entrepreneur – Cheap for the Company**
Nothing to pay back - but founders are diluted. Think about that, when company valuation passes a gazillion.
- **Possible mismatch in longterm objectives**
The investor wants a rapidly expanding business – to be sold at the right time, whereas the founders may have completely different personal goals and they are probably also more risk adverse

EXIT

The inherent consequence of equity financing

Investor converts assets to cash and pull out

- | | |
|---------------------------------------|------------------------|
| • IPO: Initial Public Offering | Rare but rewarding |
| • Trade Sale | Acquisition |
| • Management buy-out/buy-in | Not best but ROI > 0 |
| • Earn-outs | Even worse but ROI > 0 |
| • Repayment of loans | Not sustainable for VC |
| • Enforcing preferences | Cutting the loss |

Capital types in Business Development

- **Before Kick-off**

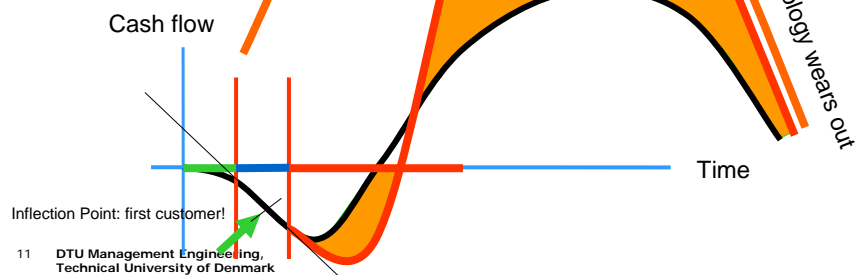
Pre-seed investment: own resources, FFF, in-kind, first customer
 Venture Cases: also special share capital (pre-seed)

- **Start-up**

Seed investment: share capital, special loans, own money

- **Growth and commercial development**

Early stage, 2. round etc.: share capital, ordinary + special shares



Investors

Pre-seed

FFF: the Business Angels
 DK: Innovation environments
 US: Small Business Agency (SBA)

Seed – Early Stage

SEEDCapital Denmark
 Business Angels
 Venture Capital companies (VC)
 Vækstfonden

Second round, follow-on

VC and Corporate Venture Capital
 Credit Institutions
 Banks
 Vækstfonden
 Some stock exchanges like First North

Impact of the economical crisis:

Investors move up in the market =>

No money in the seed – early stage segment =>

Business development strategy adopts to

- FFF
- First Customer opportunities and
- Slow self-financed sustainable growth

Venture cases become even more rare

Investor's Criteria for Interest

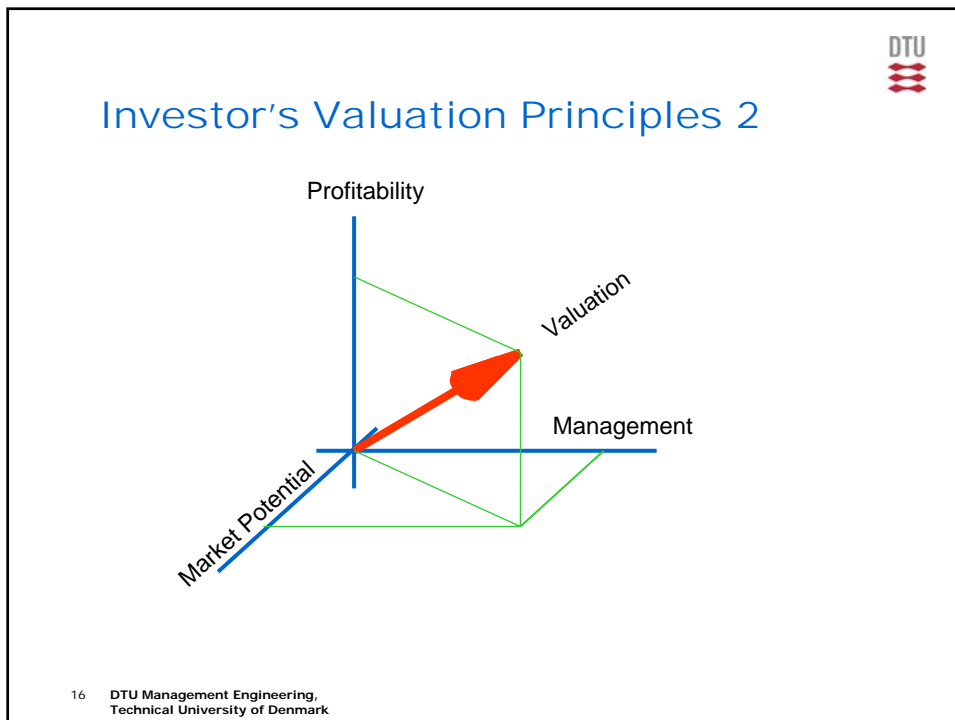
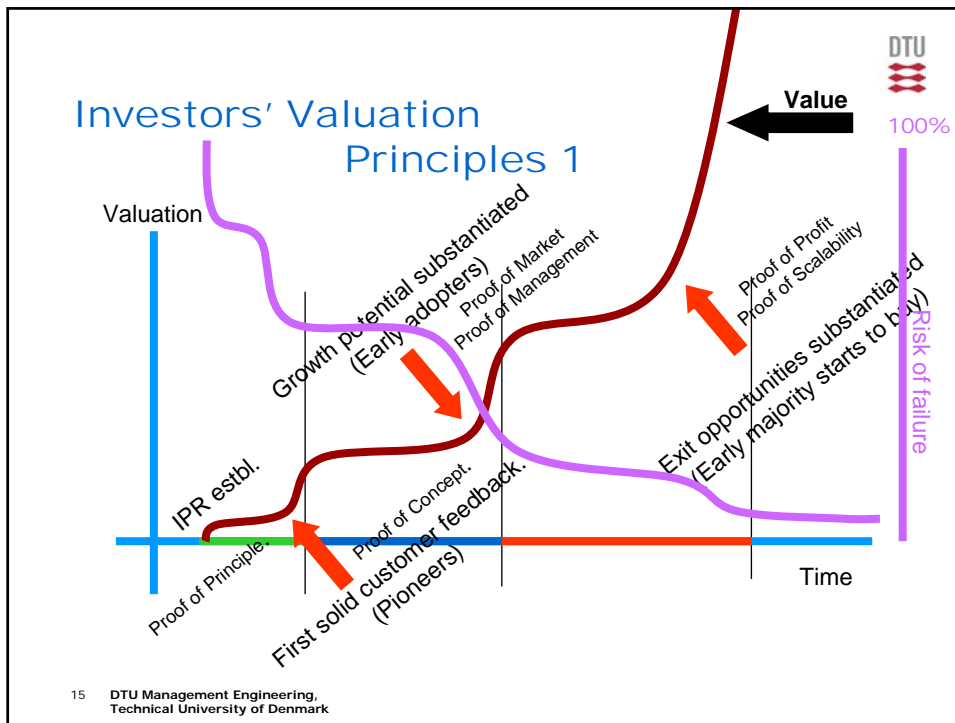
4P

- **Perspectives** *Pain, market size/share exit-op.*
- **Persons** *Track records, competencies, ambition*
- **Platform** *Proof of principle, concept, value, pull, profit*
- **Process** *The project acc. to the Business Plan*



Comments:

- Must be a Venture Case: ROI > 10 in less than 5 years.
(126 rule applies too: 100 mio in T/O, 20% profit in less than 6 yrs)
- The team is the single most important precondition
- Platform: the more commercial proofs, the better.
Commercial proofs reflect risk and competence



Dancing with Woolves

Or how to deal with investors

- **Capital always Wins**
- **Your opponent has done this many times**
- **Your opponent is not depending on you**
- **Your opponent has lots of time**

Negotiating tactics:

- **Freedom of Maneuvering**
Never enter negotiations without having fall-back positions.
- **No major payments that jeopardize your project**
Your investor will find out at "due diligence"
- **Don't go for money unless you can do without**
Make it clear from the beginning that you actually don't need it
- **If you are asked for exclusivity: it costs** (all claims cost)
Exclusivity reduces your freedom of maneuvering
- **Consider to get more investors into the game – transparently**
- **The more proofs before investment – the better**
- **Strategic partners also an asset**
- **Get yourself a management team and a battle-proven consultant before opening the game**

EXAMPLE: GBQ Ltd.

Capital need: DKK 1.5 mio -> Proof of Business

app. DKK 10 mio -> Proof of Profitability

Kick-off: DKK 550.000 to reach Proof of Concept

Founders + pre-seed investor

Private equity

First Milestone: DKK 1.000.000 to reach Proof of Pull

Pre-seed investor: private equity

Second Milestone: DKK 10.000.000 to reach Proof of Profit

Venture Capital Company: private equity

Exit: Profits (EBITDA) > 20 mio. DKK/yr.

(Earnings Before Interest, Tax, Depreciation and Amortization)

Valuation based on Price/Earnings (P/E) ~ 10

Kick-off

DKK 125.000 shares

Shares: founders: cash contribution
 founders: non cash contribution (patent)
 pre-seed investor: class b shares with
 liquidation preferences

Founding			
Funding goal: DKK		600.000	
	Contribution	Share Price:	1,00 DKK per share class A 20,00 DKK per share class B
	Nominal	Contribution	Ownership Ratio
Founding Team, cash	50.000	50.000	40,00% Class A
Founding Team, non-cash	50.000	50.000	40,00% Class A
Investor A	25.000	500.000	20,00% Class B = liquidation preference
Total	125.000	600.000	100,00%
Total cash contribution at kick-off:		550.000	

1. Milestone

Contribution through capital expansion
 Increased valuation accepted by investor due to
 commercial results

Capital Expansion 1.		Valuation pre-money		7.000.000 DKK					
Funding goal: DKK		1.000.000		Share Price:		56,00 DKK per share			
	Nom. ante	OR ante	Value ante	Contribution	New shares	Value post	OR Post	Nom post	
Founding Team	100.000	80,00%	5.600.000	0,00	0,00	5.600.000	70,00%	100.000,00	
Investor A	25.000	20,00%	1.400.000	1.000.000,00	17.857,14	2.400.000	30,00%	42.857,14	
Total	125.000	100,00%	7.000.000	1.000.000,00	17.857,14	8.000.000	100,00%	142.857,14	
Capital expansion: from				125.000,00 DKK	- to	142.857,14 DKK			

2. Round

Contribution through capital expansion
 New VC investor enters
 Funding goal: DKK 10 mio.
 Achieved pre-money valuation: DKK 10 mio.

Capital Expansion 2.		Valuation pre-money		10.000.000 DKK					
Funding goal: DKK		10.000.000		Share Price:		70,00 DKK per share			
	Nom. ante	OR ante	Value ante	Contribution	New shares	Value post	OR Post	Nom post	
Founding Team	100.000	70,00%	7.000.000	0,00	0,00	7.000.000	35,00%	100.000,00	
Investor A	42.857	30,00%	3.000.000	0,00	0,00	3.000.000	15,00%	42.857,14	
Investor B	0	0,00%	0	10.000.000,00	142.857,14	10.000.000	50,00%	142.857,14	
Total	142.857	100,00%	10.000.000	10.000.000,00	142.857,14	20.000.000	100,00%	285.714,29	
Capital expansion: from				142.857,14 DKK	- to	285.714,29 DKK			

EXIT

Venture-case criterion: Rule 126:

100 mio T/O, 20% revenues (EBITDA = DKK 20 mio.) in 6 years

Valuation principle: Price/earnings

With profits (EBITDA) = 20 mio. DKK and P/E ~ 10 (Solid and perspective company):

Price: 10 X 20 mio. DKK = 200 mio. DKK

Exit		Valuation :		200.000.000 DKK			
		Share Price:		700,00 DKK per share			
	Nominal	Ownership	Share value	Cash invested	Return on cash investment		
Founding Team	100.000	35,00%	70.000.000	50.000	1.400		
Investor A	42.857	15,00%	30.000.000	1.500.000	20		
Investor B	142.857	50,00%	100.000.000	10.000.000	10		
Total	285.714	100,00%	200.000.000	11.550.000			