Raising Venture Capital: Managing The Process For A Medical Start-Up

Presented by:

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When raising venture capital, thorough planning will help you obtain sufficient funds to achieve your milestones at an acceptable valuation, from value-added investors and with minimal disruption to your company. Today I will offer you some guidelines for success.

The amount of money you plan to raise should be enough to enable you to accomplish key milestones that will either make your company self sufficient or will enable you to raise additional funds at a higher valuation. Ideally, your current round of financing should have a valuation above the last round price (if there was previous financing). Higher valuations enable management to own a greater percent of the company.

Seek the backing of value-added venture capital investors who can help to increase the worth of your company. These investors can offer strategic advice based on their knowledge of your industry; guidance stemming from prior operating experience; vital network connections to potential management, board members and professionals (patent attorneys, law firms, consultants); and help in achieving liquidity through a merger, acquisition or initial public offering.

Plan to complete the financing as quickly as possible so that the disruption and diversion of management doesn't cause your company to falter.

Fund Raising Essentials

Before you begin raising venture capital, prepare a written business plan. This document should include an executive summary, followed by an overview of markets and marketing, technology and products, clinical/regulatory plans, manufacturing and operations, the management team, and financials. The financial section should have a discussion of your capital requirements and how the money will be used. Typical business plans are 20 to 50 pages in length. (See Table I.)

Your next step is to prepare for the due diligence process. "Due diligence" is the analysis and evaluation conducted by firms considering an investment in your company. Its focus is primarily on three variables: your management team, market opportunity and technology.

Prepare a list of references on key management team members, with names, addresses and phone numbers. Also develop a list of references on your technology – perhaps your scientific advisory board or experts in the field. A list of your customers or beta sites will be valuable. If your product is not developed, compile a list of people who will attest to its need.

If you have been in business for a year or more, investors are likely to request audited financial statements. Most investors will also review issued and pending patents. Have your patent firm prepare a status report on your patents, so you can verify that your products are proprietary and that you are not encumbered by the patents of others.

Timing Is Important

Begin raising money well before your coffers are empty. Venture financings can be completed in one month but may take as long as four months.

The time to begin raising venture capital is after you complete a significant value-added step. Major increments in value usually accrue in management team recruiting, technology development and market verification. (See Table II.) The capital you raise should be enough to enable you to achieve your company's next set of milestones, which will either take you to liquidity or increase your valuation and allow further financing.

Be sure your milestone objectives are achievable. Raising new venture capital is difficult when you fail to achieve the objectives that were established for a previous financing.

Try to avoid raising money during the summer or between Thanksgiving and New Year's Day. Many venture capital partnerships require investment approval by all partners, some of whom may not be available during these periods.

Targeting Venture Firms

Presently 625 venture capital partnerships manage over $30 billion dollars. These firms specialize by industry, geography and stage. Some invest small amounts, $50,000 to $100,000, while others will not join a financing syndicate if they cannot invest $1.5 million dollars or more. Determine the preferred investment range of the firms you target, to ensure that your financial objectives are compatible with theirs.

Also try to identify venture capital partnerships which have invested in your industry and your geographic region. The experience they have acquired with other companies in related (but not competitive) markets will be helpful to you. It's important to ask whether they have competing investments that would preclude their consideration of your company.

TABLE I

BUSINESS PLAN OUTLINE

I. Executive summary/company strategy

II. Markets/marketing
- A. Markets
- B. Competition
- C. Forecasts
- D. Selling and distribution

III. Technology/product
- A. Technology description
- B. Development plan
- C. Proprietary protection

IV. Clinical/regulatory plans

V. Manufacturing and operations
- A. Facilities
- B. Equipment
- C. Process
- D. Cost of goods sold

VI. Management team

VII. Financial review
- A. General discussion
- B. Profit and loss
- C. Balance sheet
- D. Cash flow (sources and uses)

VIII. Risks

IX. Appendices

If you have previously raised venture capital, determine whether existing investors plan to invest again. The failure of current investors to support the company will dramatically reduce your chances for a successful financing.

Target lead investors. They tend to have a solid reputation, and they are able to attract other venture capital firms into the financing syndicate. Lead investors usually negotiate the terms of the deal. If you currently have lead investors who are willing to lead the new financing, your job is simplified.

Ask potential investors if they require a board seat or are content to be passive. You may need to expand your Board of Directors in order to obtain funding.

You will spend a lot of time with your investors over several years. So use your network as well as references to evaluate each venture capital firm's reputation. Determine if the firm has added value to its portfolio companies. Also try to gauge the personal chemistry between you and the firm's partners.

If you plan to raise additional money in the future, target venture capital investors who will have money to support another round of financing.

Because some venture capital prospects will not be prepared to invest at your proposed price, send business plans to more investors than you need. If you are raising $3 million, for example, send plans to enough firms to complete a $6 million financing. Don't send your plan to too many firms, since this depersonalizes your approach and makes your company appear "shopped around."

Managing the Evaluation

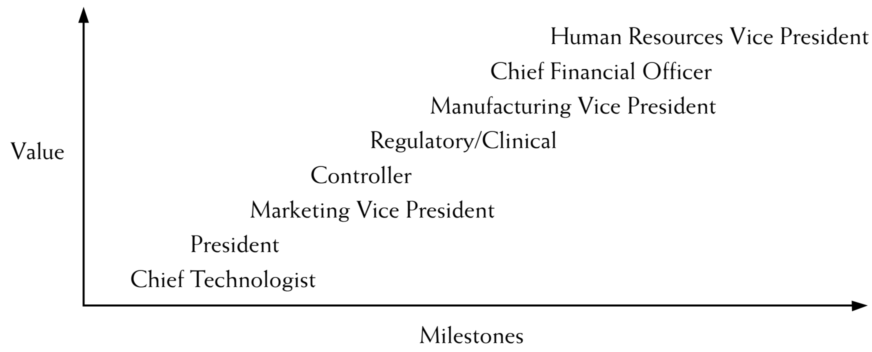
After you identify and screen potential investors, send a business plan to those who have expressed an interest in your company. Someone from the venture capital firm – preferably a partner who can make decisions and speak for the partnership – will then begin the due diligence process, evaluating the data and information you divulge in your business plan. The following are tips on managing this due diligence review.

I. **Tell Everything** – Disclose both good news and bad news. Venture capital investors are realistic and don't expect everything to be perfect. If you fail to identify potential problems or risks, you will have unhappy investors who will question your integrity if these problems surface after they invest.

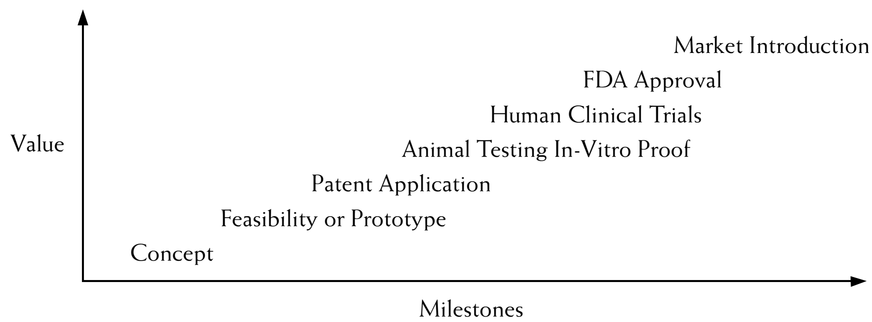
II. **Ask for Feedback** – Solicit feedback periodically so you can gauge whether or not prospective investors are seriously

TABLE II

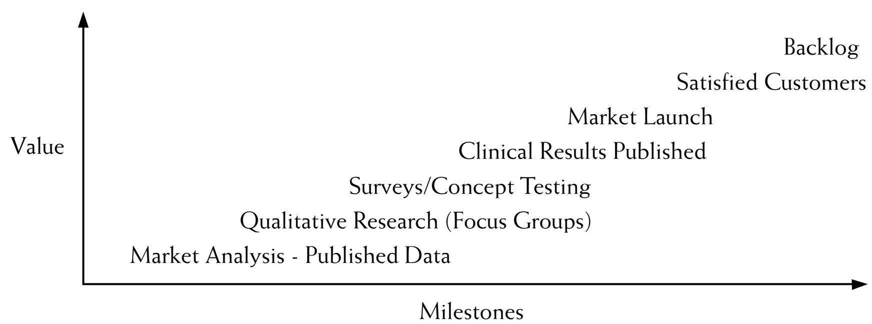
ADDING MANAGEMENT VALUE



ADDING TECHNOLOGY VALUE



ADDING MARKETING VALUE



considering your company. If a high percentage do not appear positive, you may want to increase the number of firms you contact.

Typical statements that suggest a lack of investment interest include the following. "We have a lot on our plate." "We're presently raising money for a new partnership." "It'll take us awhile to get up to speed." "Call us when you have a lead investor." "We'll be in your area in three weeks." "We haven't invested in companies like yours before." No contact from the firm for seven days often means you are not a top prospect for them.

III. **Reserve Time –** Allocate sufficient time for your management team to complete the financing. You can expect members of senior management to spend up to 50% of their time interfacing with investors and answering questions prior to closing the financing.

IV. **Manage Cross Talk –** If your company is being evaluated by several investors, try to manage the communications among them. Venture capitalists will ask for the names of other firms considering an investment. Don't divulge the names until one of the firms signals an intent to negotiate, because both positive and negative biases will be amplified.

V. **Negotiate Price and Terms –** When a venture partnership concludes that it wants to invest, suggest a price at which you would like to complete the financing; but be flexible. When a firm makes an offer, determine how it was calculated. If the offer is not acceptable, ask if the price is negotiable. Many investment offers have fallen apart because of management intransigence on the valuation. Also pay careful attention to the investment terms (the liquidation preference, redemption rights, etc.). Good legal counsel will help you avoid adverse terms that might offset a favorable company valuation.

VI. **Analyze the Investment from the Perspective of the Venture Capitalist –** Calculate the rate of return you are offering investors to insure it is acceptable to the venture partnerships you are targeting. Table III shows representative rates of return expected by venture capitalists at various stages of investment. Create a financial model for your company, making assumptions about when you will raise additional money and how much cash you will need; then project a liquidation value. Calculate the amount owned by each investor and determine each investor's rate of return.

VII. **Request Return of Plans** – After the financing is complete, send a letter to the firms which do not invest. Thank them for evaluating your opportunity, and request they return the business plan and other confidential information.

An Example To Guide You

To clarify certain points I have made, suppose that Medcap, a venture capital partnership, received a business plan from NewCo, a start-up company, in February 1987. The company's founders had developed a prototype of a medical device. The product was a single-use device with a high gross margin; the estimated market size was $200 million; and the capital required for development and testing was projected at $1.5 million. A patent application had been filed.

After four weeks of due diligence, Medcap invested $1.5 million in NewCo at a price of $1.50 per share. Based on this price, the company's valuation was $1.8 million before the venture financing and $3.3 million afterwards. (The pre-financing valuation equals the total number of shares outstanding prior to the new financing, multiplied by the price per share of the financing. The post-financing valuation adds the total amount of money being raised.)

In April of 1988, a business plan for NewCo's next round of financing was prepared and mailed to five venture capital firms. At this time, the company was preparing to launch its first product, and a second product had been developed. A Director of Marketing and a Chief Financial Officer had been hired, and production for the second product had been scaled up.

By the end of May, all five partnerships offered to invest in the company, at the following prices per share and amounts.

Venture Capital Partnership	Price Per Share	Proposed Investment (000)
A	$ 3.50	$ 1,500
B	$ 5.50	$ 1,500
C	$ 4.75	$ 2,000
D	$ 6.00	$ 500
E	$ 5.10	$ 1,300

An analysis of patents in process raised concerns with Investor B. Although the patent counsel for Investor B confirmed the strength of the patents, the company and Investor B agreed to a new price of $5.25 per share with Investor B taking the lead. A total of $4.6 million dollars was raised, of which $3.1 million was from current investors. The post-financing valuation was $17.0 million.

Closing Comments

As illustrated by this example, the best time to raise venture capital is after you have completed a value-added step and have written a business plan. Direct your efforts toward reputable venture capital firms which have previously invested in your industry. Prepare carefully for the due diligence process, and leave nothing to chance. Successful venture capital financing requires thorough planning.

TABLE III

EXPECTATIONS AT VARIOUS STAGES

Financing Round	Business Objectives (capital use)	Expected Annual Return	Time To Liquidity (IPO or merger)
Seed	Product Research Market Research Preliminary Plan	75 - 100%	5 - 8 Years
Start-up	Product Development In-Vitro/In-Vivo Proof Complete Management Team Confirm Market Size	50 - 75%	4 - 7 Years
1st, 2nd, 3rd rounds	Clinical Trials Selling Manufacturing Expand Work Force	30 - 50%	3 - 5 Years
Mezzanine	Prepare For IPO	25 - 30%	1 - 2 Years
Public offering	Market Development New Products	10 - 20%	Immediate

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De Novo Ventures is a lead venture capital investor focusing on the early stage financings (the seed, start-up and first round) of medical companies in the western U.S., particularly in California.

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