Business Model Development

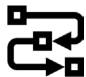
Fundraising Guide Overview

Objectives

- Understand the various stages of funding
- Evaluate what kind of fundraising is needed to bring forth the new technology
- Gain knowledge on the different types of investors and what they expect from the transaction

Outcomes

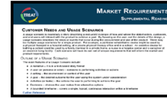
- Develop an investment plan for the technology
- Properly communicate and present to potential investors, partners, and stakeholders



Next Steps

- Seek the appropriate level of funding - develop and maintain those relationships
- Review Fundraising Materials Guide and develop collateral

Relevant Resources



Market Requirements

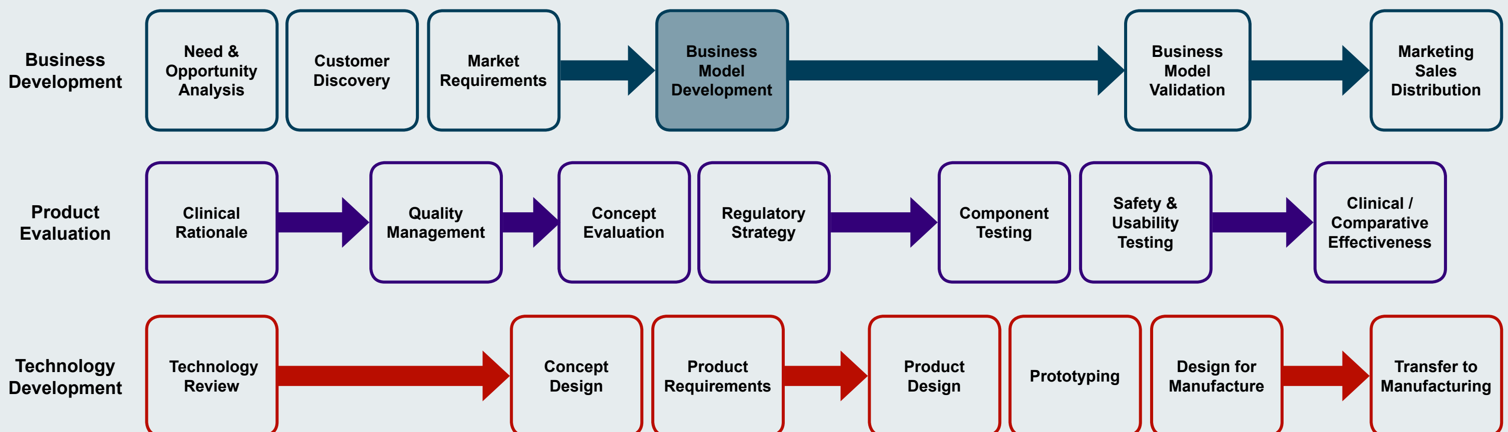
Supplemental Reading

Business Model Development

Supplemental Reading

Funders Presentation Storyboard Worksheet

Commercialization Methodology



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Business Model Development

Fundraising Guide

Introduction to Fundraising

In the following module we will cover different ways to receive funding for your innovation and why it is necessary. We will discuss the difference between dilutive and non-dilutive funding, understand where in your development funding is important, take a look into the different types of investors, and specifically what can be expected in pitching your idea and working with investors.

Raising Money - here's what to expect

Developing your tech into a product can't be done in a vacuum and someone has to do the work to translate the tech into a product. Since magic isn't a viable translation tool, we'll have to rely on human knowledge and resources we don't own in order to translate the technology from idea into a product that others see value in and want to purchase.

Elsewhere in these guides are the methods that explain the process of how to translate the technology, identify a viable pathway-to-market and revenue stream that allows for a return on investment which will meet your individual goals. Not covered is what to expect once the fundraising discussions start. After all, without funding none of the above or aforementioned activities will be accomplished in a timely manner or at all.

The need for translational funding varies based on the how far along the development pathway the project is. A further description of this will follow – as a starting point, understand that funding which originates from beyond your own bank account falls into two categories. It is either dilutive or non-dilutive. When a potential investor wants to give you cash, they want something in return. If what they want is a percentage of ownership, this is described as **dilutive funding**. Dilutive funding results from investments made by Angel investors, Angel groups, Venture funds, partnerships and possibly family/friends. Dilutive funding refers to a watering down of your ownership percentage. If you are the sole owner, you start off with 100% of the equity of the newly formed company. If there are two owners, you will need to come to an agreement as to who owns what percentage of the company and this agreement may take the form of a partnership agreement (not covered in this guide). Dilutive funding will reduce your equity from 100% to something less. How much less is based on a number of factors; company valuation, amount of investment (equity) which is being infused to the company and risk of failure. Cash or investment for which an investor does not want a percentage of ownership in return for is called **non-dilutive funding**. Examples of non-dilutive funding includes grants, debt, and gifts. Non-dilutive funding doesn't affect your ownership percentage.

Stages of Funding Aligned with Development

Early Stage - family, friends, grant financing

Early stage development involves proving business feasibility. Business feasibility is a first step in the commercialization process to assure financial viability of the project, and it isn't nearly as expensive as technical or clinical feasibility. It is important to think about your desired outcome when it comes to financial viability. Financial viability means different things to different people; it could mean making a million dollars or simply making back your investment. Whatever your definition or ambition for the project, early stage development involves assuring that the business viability will meet those aspirations at the minimum.

The process of early stage business feasibility involves utilizing free resources (available on the web), performing free or very low-cost customer interviews, and assessing potential risks. Early stage doesn't mean building a prototype and turning it into a product. Assuring the feasibility of an innovation, technology or product idea involves understanding business models, market threats, revenue challenges and intellectual property hurdles which may inhibit your success. Once an objective analysis has been completed and no big or insurmountable hurdles have been identified, the next step is to assess the potential that the business or licensing opportunity is a viable one and worth the risk of time and money to translate the idea into a product. The monetary requirement to do this work is pretty low. Intellectual property searches, competitive analysis, and investigating potential licensees require phone conversations and possibly attending a conference. These activities serve to lower risk and lower risk translates into a better investment

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opportunity.

It's worth mentioning that the above activities are focused on business feasibility. Technical feasibility is important and necessary. However, given that technical development is expensive, it is worth knowing whether the product is worth developing from a business/market perspective prior to investing time, energy and money on product development.

Dilutive funding raised at this stage is very expensive in the sense that your project is at high risk, so to receive funding, most investors would expect a lot of equity. Due to the challenges and cost of raising equity in the form of dilutive funding, it's best to budget very judiciously while investigating business feasibility. Below is the TREAT Commercialization Methodology that shows the activities which comprise Early Stage.

As learned elsewhere in these guides, risks are to be mitigated. In early stages, the biggest risk is whether or not a business could be viable and deliver a return on investment.

Here are the sources of funding that are available to an innovator/entrepreneur at this time:

Non-Dilutive: Gifts and loans from Friends/Family, research and private foundation grants, SBIR/STTR

Dilutive: Friends/Family, Angel investors

Note - Friends/Family show up in both dilutive and non-dilutive categories because a loan or gift would be non-dilutive. Even if you are paying back with interest, you are still retaining ownership. If the investment is in exchange for a percent of ownership, that's dilutive. It's a good idea to confirm the motivations and intentions of your friends and family before they transfer cash to your effort.

Middle and Late Stage - seed round financing

The commercialization graphic below again shows what activities fall into this stage. At this time the project has been vetted (business and early technical feasibility have been proven) and an innovator can say with confidence that there is a market for this innovation and can expect a return on investment commensurate with the interest of the entrepreneur.

This is a good thing because now comes more expensive product development work. The further toward the left of the commercialization methodology the more expensive the activities, the more rigor required for quality control, satisfy investors, regulators, and need for meeting standards. Still not as expensive as going to market and scaling up, but more than early development. At this point, product development work becomes more expensive. The further toward the right that you move on the commercialization methodology chart, the more expensive the activities become and the more rigor is required for quality control to satisfy investors and regulators and to meet standards. While not as expensive as scaling up manufacturing to go to market, it is more so than early development.

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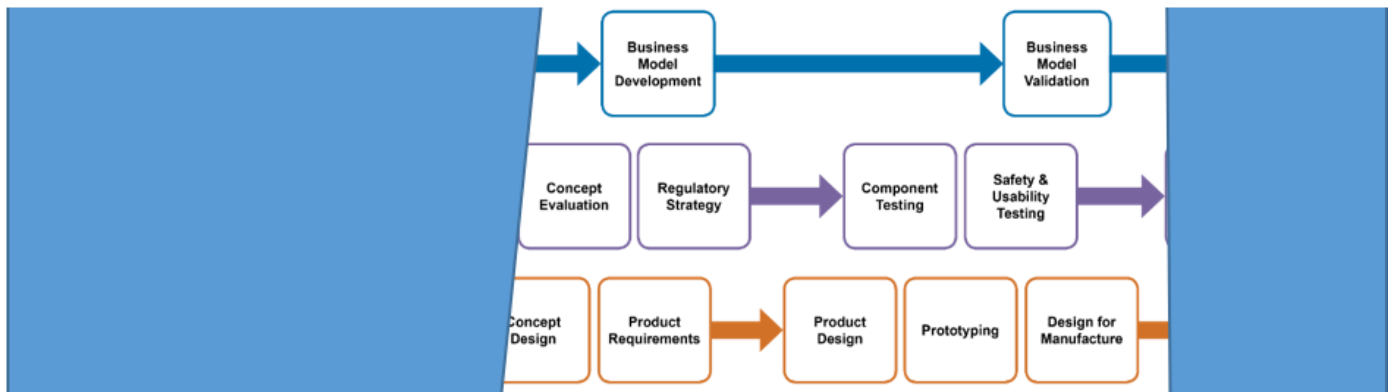

Here are the sources of funding that are available to an innovator/entrepreneur at this time:

Non-Dilutive: Wealthy Friends/Family, SBIR/STTR

Dilutive: Wealthy Friends/Family, Angel, Angel Groups, Venture Investors

Going to Market & Scaling Up - series round financing

Fundraising at this stage has greater impact than ever before. The amounts to raise are larger and key for go-to-market implementation and sales and ramping up production capacity. As the funds required at this stage are larger than ever before, investors impose more rigor and their expectations on the innovator/business to achieve results are higher. The steps in the graphic below represent go-to-market and scaling up.

Investments in this stage are coupled with more than just a percentage of ownership. New restrictions imposed on the innovator and startup business will include governance and leadership changes to allow investors greater control over direction of the company. If the innovator lacks the skills to lead the business at this stage, it is common that the innovator will be replaced by a leader who has the appropriate skills.

Here are the sources funding that are available to an innovator/entrepreneur at this time:

Non-Dilutive: Wealthy Friends/Family, Grants (e.g.: PCORI, SBIR Phase II), Partnerships

Dilutive: Wealthy Friends/Family, Angel, Angel Groups, Venture Investors, Corporations, Initial Public Offering (IPO)

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Fundraising Mechanisms, Investor Motivation and Documentation

Creating investment documentation has upfront costs which are borne by both investor and innovator. When the project is in its infancy there is little interest in bearing legal expenses to create formal documentation (a reason that early investment may be informal). As the size of the investment increases so does the formality and back-and-forth negotiation to reach an agreement.

Innovators/Entrepreneurs that reach investment stages often consider deal documentation as an impediment toward access to the transfer of cash. This is due in part to the time it takes to negotiate the elements which make up the content of the terms and conditions, formalizing these elements into legal documents, and the inexperience of doing the process for the first time.

Innovators / Entrepreneurs can reduce their angst about fundraising by developing an awareness of what is required at each stage and by creating the documentation that is appropriate for their business' stage. At a minimum, newly formed startups need to:

- Formalize the business by creating a legal entity: Articles of Incorporation and State Registration
- Create an equity structure: equity agreements; equity incentive plan
- Develop employment agreements (if the business includes anyone other than yourself)
- Create Partnership agreement (if there is a partner)

Grants

Investment through grants is an entire industry. Grants by their very design are non-dilutive. Motivations for a grant award are unique to the granting agency or organization that originates the funding opportunity. The federal government grants money in exchange for research, and translation of that research (or other innovation) toward helping solve challenges in our society. Other granting opportunities are foundations, associations and even private individuals.

Research grants offered through the federal government for basic research are applied for and won by researchers who work at universities. The federal government gives out grants because the research has the potential to help society, but due to the high risk, it would not be funded by industry.

Beyond basic research, the federal government funds commercialization efforts from researchers and private companies with inventions that solve critical and societal needs. This grant program is called SBIR and STTR (Small Business Innovative Research and Small Business Technology Transfer, respectively). Winning an SBIR/STTR requires rigor in both application for the funds and execution of the award. See www.sbir.gov for further guidance.

Associations and foundations may also offer grant awards to further science as it relates to their own interests or areas of focus on their constituents. Visit the websites for an association or foundation to learn more about a specific funding opportunity.

Documentation needed for grant funding vary by the granting organization. SBIR/STTR grants are likely to have the most stringent requirements compared to other granting organizations. SBIR/STTR grants are applied for online by responding to funding opportunity announcements.

Family & Friends

Family and Friend investors have varying degrees of formality for documenting investments which will be dependent on the investor and/or their attorney's wishes, as well the type of funding (dilutive or non-dilutive). The range of documentation may vary from nothing (verbal only and not advisable) to sophisticated financial instruments which document the transaction (payment in exchange of "what"), terms and conditions of the agreement, and repayment of investment (if appropriate).

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Family and friends are more likely to be motivated to invest because of your association with them rather than on a financial return on investment. It's not that family or friends do not want their money back (and interest), it's more because they want to help you succeed.

Seed Round (angel investors, angel groups, incubators, accelerators)

Investing in a company (like yours) that is not registered with financial authorities requires the investor to be accredited. An accredited investor meets minimum thresholds of income, net worth, asset size, governance status or professional experience. Angel investors are accredited individuals. Incubators and Accelerators are also accredited.

Seed financing is used by a startup company for market and product development. Some of the money is also directed toward hiring consultants or individuals who have skills that are relevant in this early stage.

Seed investors require varying degrees of documentation, requiring more rigor and in-depth discussions to reach agreements. Documentation will also vary based on investors' experience and professionalism as well as their reason to invest (think social cause vs. profit motive). Seed investors know that investing in your new idea is inherently risky, and want a return that is commensurate with that risk.

Seed investors have varying motivations; some are strictly financial, and others are based on personal interest and an idea that resonates with them. As Angel investors have no personal tie to you, they will most likely not be swayed by your great idea or personal charm. Rather, Angel investors want to understand your motivation and what problem you are solving. They hear lots of ideas from inventors. Considering how many investor pitches they listen to, they invest in hardly any of them. What Seed investors want to hear from you is: Is this a real problem worth solving? Have you verified it? What's your solution? Have you verified that it's something buyers/end users want and will pay for? Do you have a business model that makes sense to them? Is there any reasonable chance that investing in you will result in them getting their money back and making a commensurate return on investment? Can they trust you with their money?

Series Rounds (private investors - venture investors, hedge funds, investment banks, private equity firms)

Venture Investors are privately held companies that raise money from accredited individuals. In order to attract this investment, they promise a larger financial return on this money than can be obtained by investing in the stock market or some other venue. Due to the venture investors need for a larger return on investment, they look for investment opportunities that deliver on this requirement. Venture investors typically look for companies that have verified markets with significant upward potential and demonstrated success by having ongoing customer sales. Venture investors typically invest in Series A and Series B rounds.

Seed funding helps to establish a company's track record, and **Series A** round is the next fundraising vehicle. A company raising money in a Series round is considered to be in a developmental stage and perceived as high risk. Series A funding is predominately used to optimize the product for the intended user base and monetizing the business model.

Series B round of funding is aligned with expanding market reach. The business model having been proven is considered to be less risky now and investors view this as later stage funding. Investors will evaluate ownership percentages and options with more acuity and evaluate their positions to gain an advantage with an eye on additional funding, acquisition and planning for an exit opportunity.

Series C round of funding is about perfecting the product, business, marketing, and sales in an effort to drive growth to higher levels and ready the company for an exit opportunity. Series C funding could be used to acquire a company for strategic purposes or hiring new talent that will contribute to the growth and potential.

Hedge funds, Investment Banks, and Private Equity Firms are risk-adverse investors, and thus, are likely only interested in IPOs or Series C funding opportunities where the risk has been mitigated.

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IPO – Initial Public Offering is a fundraising option for companies who have grown through the Series rounds and need additional capital for growth. Few startups ever reach the IPO level which permits non-accredited investors to purchase stock in the company via stock exchanges.

Marketing Collateral Requirements for all Investor Types

For all investor types you'll need to be able to communicate the value proposition for the product/innovation, and business opportunity. The primary tools for these are:

Elevator pitch

A verbal explanation that describes the opportunity of the product. It will naturally vary depending on the time you have available to communicate the message; whether you have only 10 seconds or several minutes you should have a polished response to the question of "What are you up to lately?"

Executive Summary

The executive summary is a one to two-page written document that will be the same for any of the investor types. It includes a brief overview of the product and more detail than the longest version of the elevator pitch.

Presentation (or pitch deck):

The presentation or pitch deck will be similar for any group and is a tool to convey to large audiences the opportunity this product presents. The flow of information should be the same as the elevator pitch and executive summary. Sophisticated investors require extensive backup materials. How in-depth a presentation needs to be can be discovered by researching the investment group.

Financial Instruments in use by Investors

Financial instruments refer to the mechanisms which structure and document the transfer of cash for something in return. Every mechanism will include a section on Terms and Conditions of the transaction.

Terms and Conditions

Terms and Conditions (Terms). Every transaction in our daily lives includes Terms. More commonly, you might have seen a Terms of Use agreement for software. Terms outline the details of the exchange. In the case of:

- Terms used in Debt financing (loans), the primary terms that most people evaluate are interest percent and repayment schedule. Additional terms are default, late payment penalty, and arbitration to name a few. The terms for transactions which include an exchange for equity are more involved than loan repayment schedules and interest.
- Terms use in Equity financing transactions are significantly more involved and complex. Topics that will be found in an equity financing terms of agreement include: definitions, completion matters, investment by investors, waiver of claims, warranties, continuing obligations, restrictions, restrictive covenants, lock in period, permitted transfers, mandatory transfers, leaver provisions, tag along rights, drag along rights, pre-emption, etc. What's written into each of these sections is negotiable. Terms are extremely important and should not be left to chance or whim of the investor.

Instruments in Non-Dilutive Financing

Loans: loan documents may be informal (think handwritten note), or formal (prepared by an attorney and include additional notices and assurances).

Convertible Debt: Multimedia explanation. A convertible debt document spells out the obligations of both parties and may include sections like: principal and interest, conversion, pre-payment terms, documents, note purchase agreement, legal and other expenses.

Convertible debt is non-dilutive up to a point. A convertible debt agreement has a maturation date (at which the note

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must be repaid) and conversion to equity clause (usually a fundraising event or liquidation of the company assets (i.e.: buyout) event. When the debt converts to equity, it is now dilutive funding. Convertible debt is known to be problematic if the company growth rate doesn't meet expectations because when the convertible note matures and the company hasn't raised additional funds or isn't able to pay the debt to the investor, the investor has the right to demand payment. In lieu of a repayment the investor has the right to take legal action similar to any loan that may be in default.

Gifts: no documentation would be required, however it makes sense to document that the money is in fact a gift.

Instruments in Dilutive Financing

Convertible equity is a form of financing that injects cash into a business and in turn gives investors the opportunity to convert, at a later date, the investment into equity (stock) based on some event (usually fundraising). Sections of a convertible equity agreement include: services and support, restrictions and responsibilities, confidentiality, payment of fees, terms and conditions, warranty and disclaimer, indemnity, limitation of liability, miscellaneous. Additional terms that may also be found within a convertible equity agreement include:

- Discount - which specifies how much more the investment is worth than the original amount when a conversion to equity takes place. i.e.: a 20% discount on 1 million investment is worth 1.2 million in equity at a later date),
- Warrants are an option in the convertible equity agreement and give the investor the right but not the obligation to purchase a certain number of securities for a certain period of time at a certain price. Warrant options are additional opportunities for equity beyond the agreed investment and discount.
- Valuation is an estimate of the worth of a company.

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