RiEcoLab

eit Manufacturing

Co-funded by the European Union

RESPONSIBLE INNOVATION-LED ENTREPRENEURIAL UNIVERSITY (Ecosystem Integration Labs)

The overall joint vision of RiEcoLab for 2030 is to develop a novel way of performing research and development in universities to ensure immediate commercialisation (spin-offs) and involvement of a large number of internal stakeholders.

PROJECT DESCRIPTION

The EILs and the IVAP will build on capacity developed around the following toolkits:

- Toolkit 1: participatory engagement strategy for facilitating the entrepreneurial discovery process;
- Toolkit 2: setting up, institutionalising and operationalising the EILs;
- Toolkit 3: embedding responsible research and innovation in the innovation spin-off strategy of HEIs;

- Toolkit 4: bridging public and private impact investors to support spin-offs;
- Toolkit 5: implementing an inclusive performance measurement system (operationally, environmentally and socially) to monitor the impact of the spin-offs;
- Toolkit 6: effective collaboration, innovation, entrepreneurship, participatory engagement, and co-creation in a digital environment. (DigComp and EntreComp).

PARTICIPATING PARTNERS

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(Lead partner)
POLAND

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BELGIUM

National School of Political and Administrative Studies
ROMANIA

Wageningen Economic Research
NETHERLANDS

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T4 Bridging public and private impact investors to support spin-offs, startups, scale-ups

WP1 – IVAP Framework and Training Material Development

Task 1.1 – Integrated IVAP Toolkit Development

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Contents

User Guidelines

This is Toolkit 4 of a set of six Toolkits developed by RiEcoLab. RiEcoLab aims to develop new ways of performing research and development in universities to improve the process and speed of commercialisation (spin-offs). The project also aims to include a larger number of internal stakeholders (academic and non-academic staff, as well as students) in the research and commercialisation processes. To deliver on its aims the RiEcoLab project will develop Ecosystem Integration Labs (EILs), which will be adapted and implemented by each participating university, by building on existing infrastructures, such as research support and technology transfer offices.

Potential audience

This toolkit can be used by:

- Students, researchers and entrepreneurs who are developing their research plan or who are interested in setting up a new commercial venture or exploiting the commercial impact of research
- Entities who support the students, researchers and entrepreneurs mentioned above and want to help them to access capital
- Public and private investors who want an overview of best practices in funding.

Learning outcomes

After reading this toolkit or attending the training, attendees should be able to:

- Identify the most important factors in a new venture to check before asking for/providing funding
- Understand what impact investment is
- Go through the fundraising cycle with a clear image of the different players involved
- Develop/evaluate a pitch
- Establish positive Investee-Investor relations
- Identify an exit strategy

Toolkit Impact

This toolkit will create a common understanding of the investment process for spin-offs, startups and scale-ups. It should therefore contribute to improved structures and conditions for people to fund their businesses and start-ups. New tools and frameworks may be developed that localise some of the frameworks and tools included in this toolkit so that the EILs are better equipped to support the commercialisation of the new businesses or research.

Executive Summary

This toolkit will guide the readers along the three steps to raise external capital: prepare to raise external capital, approach the right investors, go through the financing cycle until exit.

To start, it is necessary to have a strong team that investors can rely on. Then, the business must grasp a market opportunity with a growth perspective and, obviously, appropriate returns. If possible, patents should be envisioned. Investors require this information to be provided in a solid business plan together with other documents that should be carefully predisposed before the meeting. The first chapter of the Toolkit offers a checklist for each of these topics that funders can use to appropriately prepare for investor meetings. Along with the business model and market opportunity, readers are invited to consider the impact that a business is generating on society and the environment given the growing commitment of market actors to sustainable development topics.

The second chapter of the Toolkit provides an overview of the different kinds of capital providers and the types of businesses that they are best suited to finance. It also offers a rundown of the main step in the fundraising process.

The third chapter guides startup founders toward selling the business and returning value to shareholders and explains why companies with clear exits strategies are highly attractive to investors, and how to how to define an exit strategy early in the days. Moreover, the chapter provides an overview of exit options and valuation methods.

1 Investment Readiness Checklist

The first step to raise external capital is: being ready to raise external capital.

This section offers a rundown of the aspects that investors evaluate when making an investment decision. Through this checklist, early-stage ventures can assess whether they tick all the boxes to be attractive to private or public financiers and which areas they should eventually focus on before approaching investors to fundraise.

1.1 Business & Technology

Aims of the chapter:

- To inform entrepreneurs on which factors investors focus on
- To explain the perspective and approach of investors in fundraising
- To provide a practical list to self-check before approaching an investor

1.1.1 Team and Governance

The excellence of the **management team** is the number one factor that investors consider when evaluating a startup. Entrepreneurs can have great ideas and perfect market conditions and still come up short: for both the startup and its prospective investors, execution is key.

When evaluating teams, investors consider the following aspects (Sophia Business Angels, 2011):

- ☐ The key people in the management team: their skills, background, career history
- ☐ Any significant gaps in the expertise of the management team, also looking forward as the company grows
- ☐ Recruitment needed over the next few years, and any anticipated problems with finding and keeping the necessary staff
- ☐ Staff turnover in the last 3 years and expected in the next period
- ☐ Existence of any profit-share or other performance related schemes, and their potential costs
- ☐ Who are the shareholders
- ☐ How key non-shareholder management will be retained/incentivized
- ☐ Any significant disputes with staff, whether taken to formal proceedings or not

Make sure to have information on these points in order to tick all the boxes. Be also prepared to provide the following documents (Sophia Business Angels, 2011):

- List of all employees with job title, salary, and details of any unusual contractual terms.
- Details of any union agreements if any.
- Copy of standard employment agreement(s) used for the different staff categories.

When **assessing team and governance**, investors will verify the **skillset** of the team and their **commitment** to the company. A strong team presents extensive vertical expertise on the market addressed, possesses solid technical capabilities as well as sound business acumen, to make sure that a great product reaches the right customers at the right time. Team members should have complementary backgrounds and areas of expertise. The **founder**(s) is object of particular scrutiny and expected to be *Passionate* about the problem, *Persistent* in executing the vision, and *Coachable* in the sense that they are open to feedback and willing to iterate if there is a product market mis-fit. There are a series of additional characteristics that investors value in a founding team, for example Trustworthiness, Integrity, Curiosity, Humility, Vision, Salesmanship, Sacrifice, Leadership, Creativity, among others (Gerber, 2013). Each investor will have her own preferences on which traits are must or nice to have: knowing investors' preferences prior to approaching them can help to advance the investment process. Founders may access this information through public interviews and speeches, as well as by reaching out to current or past portfolio companies.

Not only the company needs to have the right set of competencies and able to acquire the necessary talents to execute over time, it is also crucial to put the team in the appropriate structure. In particular, investors need to have clear understanding of **governance**, meaning the set of relationships and roles within the management team, the CEO/founder(s), shareholders, investors, advisors and board of directors. Lack of clarity and common understanding of who makes what decisions and is accountable for what results can cause confusion, and slow down or prevent scaling (Koor and Associates, na): investors will pass on the opportunities that present such risks. The set up and role of the various governance bodies changes overtime as the startup scales, however at every point in time investors want to see a corporate governance structure with an organized approach that holds the founder and CEO accountable and highlights proper communication between shareholders and the board of directors (Govenda, 2021).

1.1.2 Market Opportunity

Investors also want to make sure that the business they will invest can **achieve scale**: estimating the market opportunity is an important metric to understand the long-term potential of an early-stage company. Many early-stage companies are opening up new markets, so determining overall market size is not easy (Seraf, 2021). The market opportunity refers to the unmet demand that a business is targeting: such demand need to be big enough and durable enough to allow companies to scale. In an established market, scaling means acquiring market share and growing faster than the overall market. In a new market, scaling means educating and bringing customers to adopt a new solution for a cast lower than their lifetime value.

When evaluating markets, investors consider the following aspects (Sophia Business Angels, 2011):

- What is the size of the market (i.e. niche or mass)?
- Is the competition strong or weak?
- Is the marketing and sales plan sound?
- Is there a first sale?
- Is the time to market right?

Make sure to have information on these points in order to tick all the boxes.

When **assessing the market**, investors need a **definition of the target market**, its size, the growth potential, and the existence of complementary products or services (if any). This includes a deep understanding of customers' characteristics, values, expectations or problems and their segmentation based on this information. It also implies locating existing players in the market, understanding the degree of competition and its dominant characteristics (e.g., cost competition, price competition, quality competition), identifying barriers to entry and understanding the external environment with technological, scientific, political, environmental and societal dynamics (Chehtman, 2017; Schmidt, 2018).

1.1.3 Financial Planning

Most people would think that financial projections are the number one factor that investors consider when evaluating a startup, but this is not true. This is especially because investors are aware that financial projections are unlikely to materialize as expected (Palo AltoSoftware, 2009; Berry, 2016). Nonetheless, **financial planning** is important – both for the company and the investors – as it summarizes the figures achieved by the company at the present time and how these figures will evolve in the future based on the business plan the company is looking to execute. Translating the business plan in numbers allows to understand how much money is needed today and how it will be used to achieve the mission-vision. On one hand, financial projections should be used by the company to test different growth scenarios and drive better informed decisions; on the other they are important for investors to test whether there is a good basis for growth and if the team has sound understanding of the business model. Financial planning allows to have in mind a long-term direction even though the short term varies, and to track how and why and in which direction the company moves (Palo AltoSoftware, 2009). Every business owner should have robust knowledge on how to plan for their business and how to communicate it to investors.

When evaluating financial projections, investors consider the following aspects (Sophia Business Angels, 2011):

- What are the key assumptions behind the financial projections and underlying business plan?
- What evidence exists to support these assumptions? Are the figures realistic?
- What will be the key challenges in achieving such figures?
- How sensitive is the price and volume of sales? What happens if sales develop more slowly?
- If this is a novel product or service, what evidence exists that there is a demand for it? Has any trial, market research etc. been carried out?
- Is the cost structure complete –e.g. are there allowances for extra overheads etc. as the business grow? Are there any other "holes" in the budget?
- What is the planned use of funds? Are the needs justified and is there a detailed and realistic budget?

Startup founders are often stressed about discussing financials with investors. Instead, they should be aware that investors don't expect the financial plan to be fully right: they look for realistic assumptions and expect that startups do "their homework" when researching about their market and customers. Moreover, investors usually have deep vertical expertise, market knowledge and understanding of how early stage can evolve: founders should keep in mind that investors can help building better assumptions and should welcome their comments to sound-check and improve their growth strategy and business plan.

1.1.4 Patenting and IPRs

Intellectual property (**IP**) indicates "any creation of the mind, including inventions, designs, symbols, names, and images used in commerce" (WIPO, a). The different types of intellectual property are patents, utility models, copyrights, trademarks, registered designs, and trade secrets (WIPO, a). Each type of IP protects a specific side of the product or service: **patents** and **trade secrets** for example protect technological inventions or new technical solutions /methods; **trademarks** protect your brand; **copyright** and **design rights** protect the external appearance (Singh, 2021).

A patent is "an **exclusive right** granted to the developer of a product or process that provides a new way of doing something, or offers a new technical solution to a problem" (WIPO, b). Exclusivity enables developers to earn recognition and financial benefits for the product/service/solution they developed.

For this reason, **patents are particularly important to startups/spin-offs/scale-ups** as they protect their technological innovation, raise entry barriers to competitors and ultimately give the opportunity to make a fair return on the investment of time, money and effort to put in place the technology and business model.

When evaluating technology companies investors look for patent protection as a proof of the worthiness and exclusivity of the technology being developed and/or used by the company. Namely, investors evaluate the following (Sophia Business Angels, 2011):

- ☐ Is the technology patented, or in the process of being patented?
- ☐ Have any of the company's products been developed outside the company ? i.e. by a third party organization, or by non-employed independent contractors. If so what measures are in place to ensure Copyright, Intellectual Property Rights, Patent Rights vest entirely with the company?
- ☐ Do employment contracts explicitly assign copyright to the company?
- ☐ Are any Open Source items used in the company's products?

Make sure to have information on these points in order to tick all the boxes. Be also prepared to provide the following documents (Sophia Business Angels, 2011):

- ☐ List of all intellectual property patents owned or applied for and details of scope and protection and dates of expiry
- ☐ Copy of all contracts relating to 3rd Party development of products, including engagement of individual contractors, outsourced development and/or production.
- ☐ Copy of any License agreements assigning rights to customers.

IPR is essential to transform R&D and entrepreneurial creativity into market value and competitiveness: owning IP assets usually drive current and future income in the global market. Therefore, Investors like to see that startups/spin-offs/scale-ups integrate an IP strategy into their business plan. Entrepreneurs should refrain from looking at IP protection as expensive and unnecessary: ignoring IPR can bring a price tag in itself.

Here are additional tips about IP that entrepreneurs should consider:

- Taking advantage of government schemes to encourage you to use IP rights.
- Getting professional advice/using free IP tools, e.g. ***IP Cost Tool*** and ***IP Diagnostic Tool*** *(European Commission),* **EPO IP Teach Kit** (EPO, 2017), ***Espacenet*** or ***Tmview***.
- Pursuing "Freedom to Operate (FTO)", meaning that it is commercially 'safe' for you to make or sell your product in the country in which you wish to do so, without infringing existing third-party rights (Baker, 2019).
- Keep material information confidential: consider ***Non-Disclosure Agreements (NDA)*** when disclosing talking to third parties before filing your patent.

1.1.5 Documentation

Entrepreneurs should be ready to offer an exhaustive and truthful picture of their company to prospective investors: providing consistent and transparent information about the company status is key for building trust and reputation among angels and VCs, and for securing successful financing rounds.

To proceed smoothly in investor meetings and due diligence, founders should gather a set of documents regarding their business. The most important ones are outlined below.

Business Plan

The **business plan** (**BP**) is a formal written document containing the goals of a business, the methods for attaining those goals, and the time-frame for the achievement of the goals (McNamara, na). If well thought, the business plan conveys a powerful proposition and demonstrates the soundness of the business model and its plans for growth (HBAN, 2013).

A complete BP will include the following sections, the order can be eventually re-arranged to fit your narrative (Parsons, 2021):

- Executive Summary
- Company profile
- The entrepreneurial team (background, roles and responsibilities)
- Market Analysis (customers, competition, competitive advantage)
- Product/service (technology, IPs)

- Go-to-market strategy (marketing and sales, operations)
- Organization and management structure
- Funding (Valuation & The Ask)
- Financial Projections

Focus on: Executive Summary

The executive summary is a **brief document**, usually a one pager, that offers a summary of the business plan (HBAN, 2013). It is usually the document that investors read to decide whether to invite the founder to a pitch meeting or not: it needs to be concise yet accurate.

The purpose of the executive summary is to give an overview of the vision, product/service and business model. The points that must be mentioned are the following (HBAN, 2013):

- The value proposition: address the problem and the solution, what is your great idea to address a big problem?
- A description of your product or service: what is your secret sauce to offer a compelling solution to the problem?
- An explanation of your customer base and relevant market factors: to whom are you offering your solution? How big is the target addressable market in which you are operating? What is your sustainable competitive advantage?
- The business model and future plans: how are you going to generate revenue and from whom? How is your model scalable and how will the business be assessed? Project your figures for three to five years.
- The management team: why is your team destined to succeed?
- Financial projections: what figures have been achieved so far and how will they evolve to represent an attractive opportunity able to give good returns to investors?
- The Ask: how much capital are you looking to raise?
- Any other special or impressive information about your company

Focus on: Financial Statements

The Business Plan should offer only a summary of the projected profit and loss accounts, balance sheets and cash flow statements. Nonetheless, it is a good practice to provide investors with the complete full versions of the **three financial statements** (Yaacoub, 2020):

- **Income Statement**: includes the financial performance over a specific accounting period primarily covering the revenues and expense, showing the company's revenue, operating and non-operating costs, gross profit and net profit.
- **Balance Sheet**: includes all the business's assets, liabilities and shareholders equity at a specific point in time
- **Cash Flow Statement**: includes the net amounts of cash inflows and outflows spent by the company on different assets and resources.

Focus on: Valuation & The Ask

Valuations are official estimates. They do not represent the true value of a company and are the outcome of a negotiation between parties: investors have interest in keeping the valuation low to achieve an attractive return, while entrepreneurs have interest in raising at high valuations to secure more capital for their business. Despite this common sense, investors and entrepreneurs are usually smart enough to wish for a fair valuation: on one hand, they know it is better to start off a long-term relation on the right foot, on the other settling for extremely high or low valuations has negative consequences for both parties. For a given amount of equity, raising too little capital will expose the company to the risk of running out of cash; having a very high valuation will possibly make it difficult to raise the next round at a good valuation (if at all) unless major milestones are achieved in the meanwhile. There are many available valuation methods, as the Venture Capital method or DCF valuation. Refer to section 3 of this Toolkit for more details on Valuation.

While the business plan does not necessarily need to specify the valuation of the company, it is important to clarify the amount of capital you are looking to raise and how you will use it to achieve the milestones you stated in the previous sections of the BP.

Having a valuation in mind and a specific request for capital is extremely important because it creates a benchmark: it helps investors to understand how much money are needed for the business and how the team is planning to grow. It also helps entrepreneurs to have an idea of the share of control they are willing to give up for a given amount of money. According to Paul Graham (2007): *“You should give up n% of your company if what you trade improves your average outcome enough that the (100 - n)% you have left is worth more than the whole company was before”*.

Terms of Investment

Together with valuation, the terms of investment are extremely important for the investor and the entrepreneur.

The principal terms and conditions of an equity investment are usually stated in a term sheet. Investment terms and conditions include the following (HBAN, 2013):

- Amount and use of investment;
- Percentage ownership;
- Equity and debt structure;
- Dividend and interest (if applicable) rights;
- Voting rights;
- Management incentive schemes;
- Exit arrangements;
- Management changes;
- Investor board representation;
- Investor veto rights;
- Reporting requirements and consequence of failure;
- Costs and confidentiality; and
- Steps to closing.

1.2 Impact

Aims of the chapter:

- To inform entrepreneurs of the relevance of impact investing
- To define impact investing and set the context where impact businesses operate
- To provide entrepreneurs with tools to measure and monitor their impact

1.2.1 Overview of Impact Investing

Investors are more and more concerned about the impact produced by the companies they invest in. Therefore, entrepreneurs providing a solution to a pressing social problem have a growing audience to present their business to and obtain funds from. Impact investors are a specific category of investors which present few distinctive characteristics compared to traditional financiers.

What is Impact Investing?

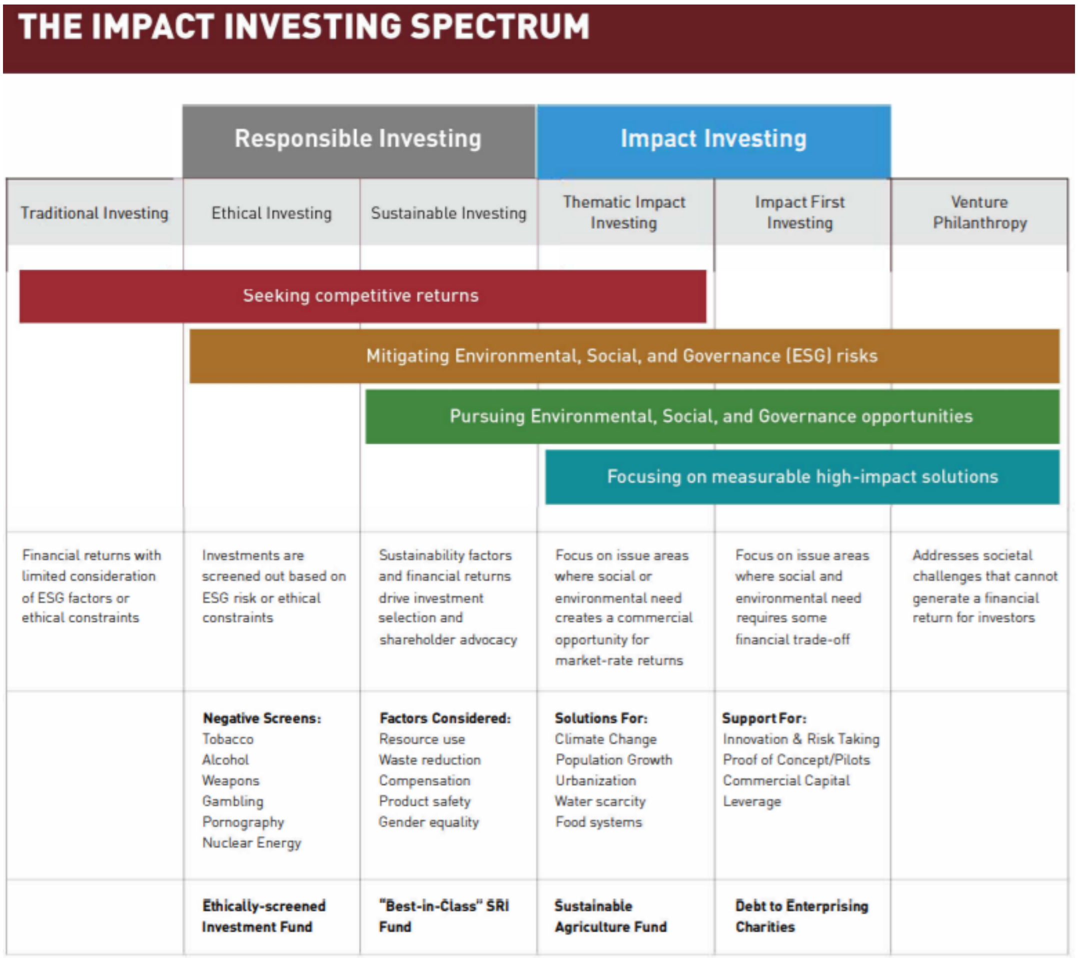
The most widely accepted definition of impact investing is offered by the Global Impact Investing Network (GIIN, 2021a*): "Impact investments are investments made* *into companies, organizations, and funds that **generate social and environmental impact alongside a financial return***". In 2020 the International Finance Corporation estimated impact investments to amount to €2,1 trillion (IFC, 2020).

<u>How is impact Investing different from other types of investing?</u>

According to the Impact Investing Guidebook for Foundations (Glencross et al, 2017), Impact investments:

- can be applied across asset classes, sectors and geographies
- have a range of return expectations and risk profiles
- can be made in non-profit and for-profit companies through debt, equity, grants and credit guarantees
- are part of a continuum of investment approaches that include traditional and responsible investing and venture philanthropy, as described in the diagram below.

Figure 1.2.1.1 The Impact Investing Spectrum



Source: Glencross et al, 2017

As the diagram illustrates, responsible investing and venture philanthropy complement and in some aspects overlap with impact Investing. However, they lack one or more of the core characteristics of impact investing: Intentionality, Evidence, Management and Field-building. **Ethical investing** (or 'negative screening') excludes companies or industries (such as tobacco, pornography, or arms manufacturing) that may negatively impact additional risks. **Sustainable investing** (or 'positive screening') considers environmental, social and governance (ESG) criteria in investment decisions, usually to mitigate risks or identify opportunities. Shareholder engagement is used to influence the behaviour and decision making of holdings. **Impact Investing** involves deliberately selecting and supporting organizations and projects that share your social or environmental mission, but considering the financial return generated, as opposed to **venture philanthropy** (Glencross et al, 2017).

1.2.2 How to Measure Impact

The goal of impact measurement is to manage and control creating social impact to maximize or optimize it (relative to costs). Managing impact occurs continuously and is facilitated by integrating impact measurement in the investment management process (Hehenberger, Harling and Scholten, 2015). According to the GIIN Annual Impact Investment Survey 2020 (Hand et al., 2020) the sophistication in impact measurement and management practices was the most significant industry progress over the past decade, yet also remains a top challenge.

There are several approaches to follow. Two of the most visited ones, the **GIIN IRIS+ System** and the **EVPA Practical Guide to Measuring and Managing impact** are presented below:

IRIS+ is a free, publicly available resource that is managed by the Global Impact Investing Network (GIIN), designed with input from hundreds of leading impact investing practitioners from around the world (GIIN, 2021b). It is the generally accepted system for impact investors to measure, manage, and optimize their impact. The IRIS+ system helps investors and companies understand how to effectively measure and manage their impact and clarity for how to improve that impact over time. The IRIS+ Core Metrics Sets are short lists of key impact performance indicators—built on standard IRIS metrics and backed by evidence and best practice—that impact investors can use to assess the effects of their investments (GIIN, 2021c).

The EVPA **Practical Guide to Measuring and Managing Impact** (Hehenberger, Harling and Scholten, 2015) targets impact investors, foundations and other public or private financiers interested in generating a positive impact on society. EVPA identifies a five-step process to set up an impact measurement system and monitor it overtime. The five-step process is as follows (Hehenberger, Harling and Scholten, 2015):

Step 1: **Setting Objectives**. The company/investor should define the scope of the impact measurement and sett consistent objectives. Setting objectives is a vital step in any impact measurement process and should be carried out both from investors and investees.

Step 2: **Analysing Stakeholders**. The company/investor should understand the value they generate for a variety of stakeholders. A stakeholder is defined as "Any party effecting and/or affected by the activities of the organization".

Step 3: **Measuring Results.** The company/investor should track and measure their own outputs, outcomes, impact and set the indicators representative for their own objectives. This step simply includes to draw expectations regarding the impacts that an investment can achieve and setting tailored KPIs to assess whether and by what extent those impacts have materialized.

Step 4: **Verifying & Valuing Impact.** The company/investor should verify that the claims regarding to positive impact achieved is true and to what extent.

Step 5: **Monitoring & Reporting.** The company/investor need to monitor, track progress against (or deviation from) the objectives defined in the first step and made concrete through the indicators set in the third step, and reporting – transforming data into presentable formats that are relevant for key stakeholders.

Key Roles and the Future of Impact Investing

The EU needs to take the necessary steps to ensure a future for impact investment. Initiatives such as the **European Green Deal** (EC, 2021a), launched in 2019 by EC, aiming for Europe to become the first climate-neutral continent by 2050, as well as the **Just Transition Mechanism** (EC, 2021b), launched in 2020, for securing that the transition towards a climate-neutral economy happens fairly, leaving no one behind, are in the right direction for supporting the practice of impact investing. Nevertheless, more needs to be done on a national, regional, and municipal level.

Besides the European Policies, Initiatives and financing instruments, and the support offered by Network Associations in the impact investing market, **Higher Education Institutes** (HEIs) **can play an important role** in the impact investments ecosystem (Hehenberger, 2020). HEIs can start by emphasizing producing research in the environmental, social and governance fields and move towards Responsible Research Innovation (RRI), help understand how the sector works by analyzing impact investment data, and last but not least, support the impact investing ecosystem by educating the future entrepreneurs and investors.

The educated "Impact Investors" together with "Social Purpose Organisations (SPOs)" or the "Impact Investees (IIs)" working together will be willing to take risks (that most other investors won't) and solve pressing social and environmental issues, creating an impact to the "final beneficiaries" benefiting from the SPOs/IIs products and/or services. By "final beneficiaries", we refer to minorities, people in poverty, people with disabilities, women, children, migrants, or the environment as those benefitting from the services or products developed by SPOs.

2 The Fundraising Cycle

The second step to raise external capital is: making sure to approach the right investor(s).

This chapter offers entrepreneurs an overview of the different financing moments and the actors intervening at each step. Through this summary spin-offs/start-ups/scale-ups can identify the right provider of capital to contact, and how to approach them to close the deal.

2.1 Investment lifecycle

Aims of the chapter:

- To provide entrepreneurs with a scheme to spot the most suitable capital provider based on his/her company's lifecycle stage
- To explain the fundamental relation between company lifecycle, risk and expected return, which ultimately characterizes the different investor types

Rounds of Financing

A company's funding needs, and the risk-return profile of the related investment, change at each stage of its life cycle. Thus, providers of funds have specialized accordingly to ensure to fill the specific needs at best while keeping the risk balanced to the return. In the table below, there is a comprehensive scheme of how the sources of capital are divided along companies' life cycle.

Table 2.1.1 Sources of funding correlated with the stage of the venture

Life cycle stages	Seed	Startup	Early Growth	Expansion
Friends & Family	O	O		
Other Partners	X	O		
Angels	X	O		
Private Equity	X	O	O	X
Banking System			X	X
Trade Credit				X
Financial Markets				X

Source: adapted from Caselli, 2021; O = good source of capital; X = best source of capital

<u>Life Cycle of a Company</u>

To understand which investor to approach, the entrepreneur first needs to understand at which stage of the lifecycle its company is and this because at each stage there are different funding purposes that can be sought for. They can be:

- Organic investment (e.g. personnel; capex)
- Acquisitions (e.g. bolt-on; transformative)
- Liquidity (e.g. full; partial; non-management shareholders; “changing of the guard”)
- Current financial performance

Commonly six stages are identified in the life cycle of a company:

i. **Seed:** founders start to create and develop the business idea. The company experiment products and products features in small batches and search for market intelligence about their customers and competitors. The company needs money to complete research, product definition or product design.

ii. **Startup**: the business actually starts, the product is fully developed and validated by first customers and early adopters. Mass production/distribution needs to start: the company needs money to cover capital expenditures and working capital.

iii. **Early growth:** this represents the moment when the company start its growth. In the professional world, this is known as “the financing of the day after”. The company has not reached profit yet and needs funding to finance additional capital expenditure.

iv. **Expansion:** in this phase, the sales keep on growing at a very high rate. Money is needed to expand and improve operations or enter new markets to accelerate growth of the business.

v. **Mature age:** this is the moment when sales growth is stable. Money is generally needed to replace shareholders.

vi. **Crisis:** in the end, when (and if) the company comes across its decline, money is needed to re-establish prosperity, or to minimize losses.

2.2 Types of Investors

Aims of the chapter:

- To inform entrepreneurs on the most relevant investors types for startups, scaleups and spinoffs
- To describe the characteristics and objectives of different investor types, their approach and investment focus

2.2.1 Overview

The cases where an individual has the ability to invest her/his own wealth and earnings in their startups are quite unrealistic or even downright impossible. In most of the cases, fledgling startups need to seek out investors to help finance their business.

The presented types of investors are public investors, private investors, public-private partnerships (PPPs), impact investors and crowdfunding.

2.2.2 Public Investors

Public investors are government agencies providing both direct and indirect investment on physical infrastructure (e.g. roads, government buildings, etc.) and soft infrastructure (e.g. human capital development, innovation support, research and development, etc.) with a productive use that extends beyond a year. Direct investment is defined as gross capital formation and acquisitions, less disposals of non-financial non-produced assets during a given period. Indirect investment is defined as capital transfers i.e. investment grants and subsidies in cash or in kind made by subnational governments to other institutional units.

According to the OECD (Muñoz, Pineda, and Radics, 2014) *Recommendations on Effective Public Investment Across Levels of Government*, public investment shapes choices about where people live and work, influences the nature and location of private investment, and affects quality of life. If well-managed, public investment is a potentially growth-enhancing form of public expenditure. In contrast, poor investment choices waste resources, erode public trust and may hamper growth opportunities.

To access public funding, it is necessary to identify a program sponsored on public entities' websites and to apply on the relative platform, e.g the [Funding and Tenders portal] of the European Commission.

Public funding has pros and cons. Advantages mainly consist of the fact that it's a cheap source of capital that requires small or no interest and capital repayments, and that the capital is provided for a longer period. The main disadvantages consist in the high level of competition to obtain the money, in the complexity of the procedure to apply and in the long-time public investor take to examine applications and assign the money.

2.2.3 Private Investors

Private investors can be **corporate** investors, **family offices** or **private individuals** (also known as angel investors, or business angels), **private equity** or **debt investors**, **banks**, **foundations**. They can provide different kinds of capital that can be more or less expensive, from grants to debt capital to mezzanine capital to private equity. While grants, as with public investors, are non-repayable funds and thus they represent the least expensive form of financing, the other types of capital imply a cost that is based on the risk of the investee. The higher the risk, the higher the return that the investor will require on the funds provided.

Debt or Equity

One of the first questions a business owner should ask themselves when considering financing is: is debt or equity the right source for your business?
Both Debt and Equity have advantages and disadvantages, as shown in the table below.

Table 2.2.3 Advantages and Disadvantages of Debt and Equity

	Advantages	Disadvantages
Debt	• No control on the company • Tax deductible • Payments are planned	• Difficult to raise if risky business (especially start-ups) • Deadlines have to be hit, whatever situation the business is undergoing

Equity	• Long term horizon • Aligned objective of company's growth • No cash drain: if the business is undergoing a downfall, the shareholders will wait to receive a compensation • Higher risk tolerance	• Control on the company and potential conflicts in managing the business • No tax deductions • Higher returns requested for the higher risk taken

Source: Elaborated from Woodruff, 2019

Equity financing

Equity financing refers to all those transactions where investors get shares of the equity of the company in return for the capital (cash) disbursed to the company. These investors do not earn an interest on their and expect to create profit mainly through capital gains, i.e. exiting from the investment by selling their shares at a higher price to someone else on the market. For mature companies, shareholders also receive dividends, early-stage investors instead do not expect dividends as they prefer their capital to be fully invested into R&D, assets, commercialization and ultimately company's growth. The private equity investor can assume a hands-on or hands-off approach. In the former case, it will intervene actively in the management of the company, in the latter the entrepreneur will drive the company. In both cases, the venture-backed company will enjoy some direct and indirect benefits (Caselli, 2021):

- **Certification Benefit**: if a private investor decides to invest it is a proof of high quality and great health of the company
- **Network Benefit**: the private investor will share contacts with potential customers, other investors, banks
- **Knowledge Benefit**: the private investor can transfer its knowledge
- **Financial Benefit**: an increase in equity leads to an improvement in the credit standing of the company.

Focus on: Venture Capital

Venture capitals are investment vehicles that focus at the very early stages of a company's life: Because the risks of investing in startup companies are much greater, the holding periods are long (ranging between 5-7 years), and the money is totally tied up and illiquid throughout VCs expect above-average returns and offer attractive payoffs for bearing that risk. To minimize the risk of the investment, VCs tend to keep an hands on approach and offer portfolio companies extra resources to help them grow, mainly in the form of market knowledge and connections.

Focus on: Business Angels

Business Angels are *"private investors who choose to make seed and early-stage investments into startup companies. Besides investing their capital, business angels also support their investee companies with mentoring and advice, expertise and network connections. Business angels are also commonly referred to as angels or angel investors*" (EBAN, 2018).

Providing both financing and managerial experience, angels increase the likelihood of startup enterprises surviving the "valley of death". Angels play an important role in the economy, up to constitute often the largest source of external funding in newly established ventures, after family and friends. The supply of startup and early-stage equity finance has to some extent become more dependent on angels, as venture capital funds are not able to accommodate a large number of small deals.

Focus on: Impact Investors

As mentioned in section 1.2.1, impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets and target a range of returns from below market to market rate, depending on investors' strategic goals.

The first reason one should consider launching impact investing vehicles is that impact investment has a critical role to play in addressing 21st-century challenges, such as persistent poverty, growing inequality, accelerating climate change, the stark human costs of COVID-19, racial injustice, and other crises and inequities that characterize our world. Indeed, the UN estimates that there is an annual financing gap of € 2.2–2.6 trillion in what is needed to achieve the Sustainable Development Goals by 2030 (UN, 2019). There is simply no way to fill a gap of this magnitude without enlisting private capital and private enterprise (Etzel, Morley and Kelly, 2021).

Private equity can effect change in ways that neither the public sector nor public market investors can. Firms are uniquely positioned to not only direct capital to opportunities that achieve meaningful outcomes for society, but also ask more probing strategic questions about a company's products and services. They can roll up their sleeves and shape operations around the triple bottom line of people, planet, and profit. That gives them powerful leverage over their portfolio companies' impact.

2.2.4 Public-Private Partnerships

Private-Public Partnerships (**PPPs**) are investment schemes that allow private actors and public bodies to co-invest to deliver services and or infrastructures for the benefit of the public. PPPs have historically been employed for building or maintaining road infrastructures, telecommunication, water plants, hospitals, housing and schooling, and more basic services. PPP arrangements are particularly important to realize risk-sharing and crowd-in effects. PPPs have several advantages among which the European Commission has identified four (EC, 2003):

- to provide **additional capital**, while **reducing the risk** for the private investor;
- to provide alternative management and implementation **skills**, thanks to the private investor's involvement;
- to provide **value added** to the consumer and the public at large;
- to provide better identification of needs and **optimal** use of **resources**.

Many actors in the financing spectrum advocate that public-private co investment and PPP schemes should be used more widely in the early-stage investment ecosystem as innovation and entrepreneurship are recognized as a source of positive externalities and ultimately a public good. Moreover, evidence suggest that pro-PPPs venture capital can achieve additional value compared to other approaches if there is an effective implementation structure and if the objectives of all parties can be met within the partnership. Some of the measures that public actors are implementing to crowd-in the private sector are (Wessner, 2001):

- Direct grants and short-term awards to develop new technologies
- Equity Capital Infusions by government or government-controlled banks
- Government guarantees for loans
- Targeted tax concessions for specific sectors and/or regions
- Hybrid funds with public guarantees

A virtuous example of hybrid fund in Europe is the European Social Innovation and Impact Fund (ESIIF) originated by FASE, a co-investment fund **matching 1:1 financings** of direct investors in EU early-stage enterprises. The fund offers a multilayer structure for different risk appetites on the private investor side. The image below summarizes the structure and expected returns from each tranche.

Despite having several advantages, it should be noted that PPPs are often complex to design, implement and manage and in some cases they may lead to an increase costs of servicing citizens.

2.2.5 Crowdfunding

Crowdfunding is not something new. In 1884, Joseph Pulitzer came up with a solution for the lack of funds for building the pedestal of the Statue of Liberty: through his newspaper the *New York World* he urged Americans to donate money, raising over $100,000 in six months (BBC, 2013).

Crowdfunding is among the alternative financial instruments harnessing internet technologies to bring those with money and those who need it closer together and aggregate numerous small investments or donations to meet large funding needs (Baeck and Collins, 2014). Crowdfunding has a number of advantages and yet is not a scheme to get-rich-easy: 60% of all crowdfunding projects fail and the average raise is less than $10.000.

Key advantages are:

- Possibly fast fundraise with no upfront fees
- Valuable feedback on the product from prospective users
- Wide marketing of the product and media attention
- Investors can track progress
- Ideas that may not appeal to conventional investors can get financed

Some disadvantages are:

- Crowdfunding platforms screen investment opportunities and reject a fair share of them just like investors
- Time and resources to build up interest before the campaign launches
- If the funding target is not reached, any finance that has been pledged will usually be returned to investors
- Failed campaigns risk damage the reputation of the business
- Unprotected business ideas (patent or copyright) are exposed to copycats

To launch a successful crowdfunding campaign, founders need as much dedication as in a traditional fundraising process: crowdfunding is about building and connecting with your community. The money part comes after you succeed with the connecting part.

The crowdfunding process involves 4 steps:

1. **Campaign Ideation**: in this phase you should figure out what are you raising money for, why backers should support you, what incentives you can offer to engage the community

2. **Campaign Design**: in this phase you should create a functional and visually appealing campaign able to convert visitors in backers through a clear and crisp explanation of your solution, supporting videos, etc. Keep in mind that your campaign is not set in stone and should be optimized along the way
3. **Campaign Promotion**: *"The most important aspect to your campaign is to share it"*, writes Sara Margulis of Plumfund, one of the largest online fundraising networks. Raising awareness and marketing your campaign is extremely important, you can do that by raising early funding commitments and boosting your campaign through different channels, including partnering with bloggers and youtubers
4. **Campaign Launch:** Monitor impressions & site traffic: good campaigns convert 4-5% of the traffic that comes to the site. Iterate and improve. Don't stop communicating with your audience.

Entrepreneurs who resort to crowdfunding should do a feasibility and research study for their product: developing the right message and promoting it correctly is essential for success.

There are several popular websites for crowdfunding:

- https://www.kickstarter.com/
- https://www.indiegogo.com/
- https://www.patreon.com/
- https://www.crowdfunder.co.uk/
- https://www.gofundme.com/
- https://www.fundable.com/
- https://www.crowdcube.com/
- https://www.mightycause.com/
- https://www.seedinvest.com/

2.3 The Investment Process

Aims of the chapter:

- To inform entrepreneurs the common steps of the fundraising process
- To provide a template on how to craft a killer pitch
- To suggest entrepreneurs how to create a trustworthy, long-term relation with prospective investors

2.3.1 Fundraising Steps

The fundraising process requires a few consequential steps, namely:

Figure 2.3.1.1 Equity fundraise cycle

Source: adapted from UCD, 2021

While the first phase is fairly straightforward, and has been explained extensively in previous chapters, the others are complex processes that require financial, legal and operational expertise. A round is often closed in a few months' times and the final terms and conditions mentioned in the term sheet are object of extended scrutiny and negotiation among the parties.

<u>Examples of Pre-fundraise:</u>

Seed stage: Trying to prove product-market fit and raise approximately $2.5 million

What entrepreneurs need to show investors:

- A credible story that someone on the team will build the product.
- A prototype that demonstrates the product's key features.
- Data from customers who have used your "minimum viable product" and given feedback
- Actual usage metrics from customers who are using your product
- Proof of product-market fit:
    - For business-to-business (B2B) startups, at least 10 paying customers who can serve as references
    - For consumer-facing startups with paying customers, at least 100 paying customers who can serve as references

  - For consumer-facing startups offering a free service, at least 100,000 monthly active users

Series A: Trying to prove your revenue model and raise approximately $6 million

What entrepreneurs need to show investors:

- For a B2B startup, a proven go-to-market model when:
  - "Customer acquisition cost" payback period is less than two years
  - Three-fourths of your sales people are meeting quota
- For a consumer-facing startup, generate at least two times the amount spent on customer acquisition on a "contribution margin basis" within 18 months (contribution margin = revenue minus cost of goods sold, minus variable operating costs)
- Proven customer success: Existing customers are buying more, so annual revenue continues to increase year after year, before the added revenue from new customers
- Proven scalability: Contribution margin (sales minus variable costs) is greater than 75 percent
- Proven market demand: Annual recurring revenue is greater than $5 million
- Proven traction: Annual recurring revenue growth is greater than 100 percent

Other criteria investors will look for: of course, investors will ask the all-important question: "Why now?" Epstein points to Uber's perfect timing by starting soon after smartphones became widely used by both passengers and drivers.

<u>Preparatory phase</u>

While value estimation will be dealt with in Chapter 3 and the documentation to present has been explained in Chapter 1, Investors screening is at the center of the first part of this Chapter.

It is important to remember that screening happens both ways, make sure to research which are the criteria that your target investor apply and to address each one of them in the deck you will share. Moreover, it is useful to draft the criteria that your ideal investor should meet to be truly valuable for your company's growth. To begin with, answer the following questions:

1. Who is the **right investor** for your business? (see sections 2.1 and 2.2)
2. Is **debt or equity** the right financing source for your business? (see section 2.2.3)

3. Does your **target investor** have adequate financial resources and risk profile to fund your business?

Ultimately, you can understand whether the person standing in front of you is the right one to on the growth journey only by building open communication and mutual trust, by presenting a solid business plan and being transparent about challenges. You should also understand the different risk profile and ticket sizes that the investor is comfortable with: some examples of generally acceptable milestones to be considered investment ready at different stages are provided below.

How to operationalize investment:

- Create a virtual data room – save pdf of signed version of all key customers / business agreements
- Document commercial arrangements / supply chain
- Own, protect and record your IP
- Review regulatory compliance and risk management – address any gaps
- Build a robust and credible financial model

Due diligence

Due diligence is the process through which an investor or a certain external entity assesses your business/startup for a given purpose, e.g. whether they want to give money, give a loan or an audit (Yaacoub, 2020). This assessment is needed to see what the gaps in the business are and, thus, what kind of help is needed, or also to check if there is fit between the startup and the investor. It implies that the business provides information to the entity requiring it and then participates to calls and visits

The due diligence exercise is intended to (Sophia Business Angels, 2011)

- Ensure that the information provided is actually true.
- Find out any additional information the investors should have been told
- Probe into the assumptions in the business plan: are they valid and realistic?
- Identify the principal risks to the business and if there is a plan to address them.
- Conduct a more detailed analysis of the current state of the company
- Further analyze the competitive environment and the company position.

In addition to these points, the aim is to get a subjective "feel" of the company –is there a good impression when you walk in the door, do people seem to be working hard and focused, or is it a mess.

As a conclusion, what does a startup need to succeed with investors?
Team, **strategy** and **transparency**.

2.3.2 Pitching

Pitching is **storytelling**!

A business pitch is a business plan that you present to your potential investors to secure funding. The pitch helps you explain your business to investors to enable them to make the right decisions.

The key elements of a pitch are:

1.The Opener: start with the most convincing statement of why you have a great idea. Often this is about the uniqueness of your solution to address a big problem. Keep it specific and not woolly. If you are already working with world class people, companies or founders that have done it before then mention them here;

2. The Problem: explain clearly the pain point (could be current or emerging) that your customers experience and you are proposing to solve. This gives the context to establishing your value proposition;

3. The Solution: state what you are offering to whom. Is it software, hardware/product, service or a combination? Do not use acronyms but explain in plain language what you have that provides a compelling solution to the problem identified. You may need to explain how you fit into the value chain or distribution channels and why the players in your industry will be keen to work with you. If you have customers and revenue then state that clearly. If not then state when you will;

4. The Market Opportunity: explain the market (segmentation, size in value, growth, drivers and influences, how many customers and competitors). Targeting a reasonable percentage of a well-defined growing market will be more compelling than a micro percentage of a very large mature market. Make sure that any values stated are about the target addressable market in which you are operating;

5. Competitive Advantage: you have competition: if you do not then there is no market for your solution. At the minimum you are competing with the way business is currently being done. Someone, somewhere in the world, is probably doing what you are proposing to do. So, you need to state clearly what your sustainable competitive; you need to state clearly your unique benefits and advantages;

6. The Business Model: state how you are going to generate revenue and from whom. You need to demonstrate how your model is scalable and how (what metrics? Customers, licences, units, revenues, margins) the business will be assessed. State what levels will be reached in three to five years;

7. The Management Team: the number one criterion used by investors. Explain why your team is destined to succeed. Avoid summary CVs; relate individual team experience to the factors that will make the business flourish. Name drop big branded companies that any of team has worked for if you can;

8. The Reward: your summary financial projections need to demonstrate that a significant return will be achieved. You should show, in summary form, three to five years revenue, overheads, losses/profits, cash balances and headcount; In some cases, it may make sense to include a key driver like number of customers or units shipped;

9. The Funding Requirement: state how much you are raising now. This should be enough money to enable you to reach the next significant milestone. If there will be a future funding round then give an indication of the scale of that round.

<u>How to boost your pitching effectiveness?</u>

Pitching to an Investor:

- Know the background of the investor that you're meeting with
- Leave time for the investor to speak
- Come with carefully prepared questions
- Know what you're looking for in the conversation
- Hold your ground on the issues that matter most

Impress with relevant content such as:

- Key Performance Indicators (KPIs)
- Financial statements prove that a business is healthy
- A short deck and a detail-laden appendix
- Competition and defensibility
- 'Next steps' documents should be prepared in advance

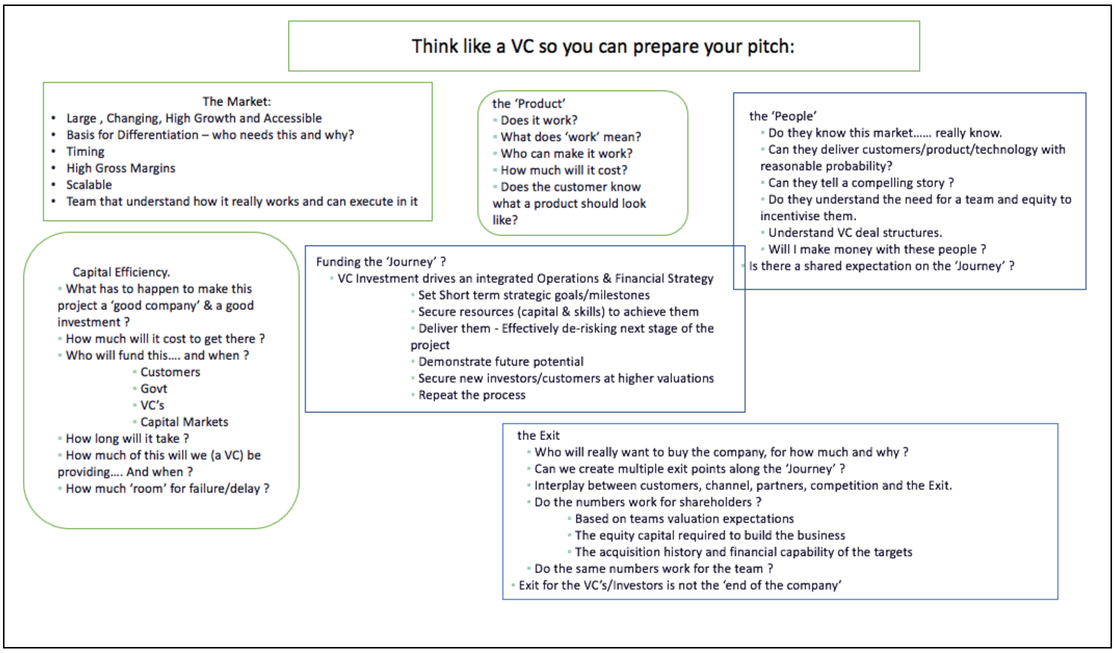
- The Power of three (ideas presented in threes are inherently more interesting, more enjoyable, and more memorable for your audience)
- Use emotion
- Make it personal
- Think WIIFM

- Use visual aids

Know what investors are looking for

- Innovations and breakthroughs that are heavily patented and highly defensible
- Founders with ambition to work with us to rapidly grow a business
- A solid strategy with clear milestones to accelerate growth & reduce risk
- Evidence of a high growth market opportunity for innovative technologies

Figure 2.3.2.1 – How Venture Capitalists think when evaluating a pitch



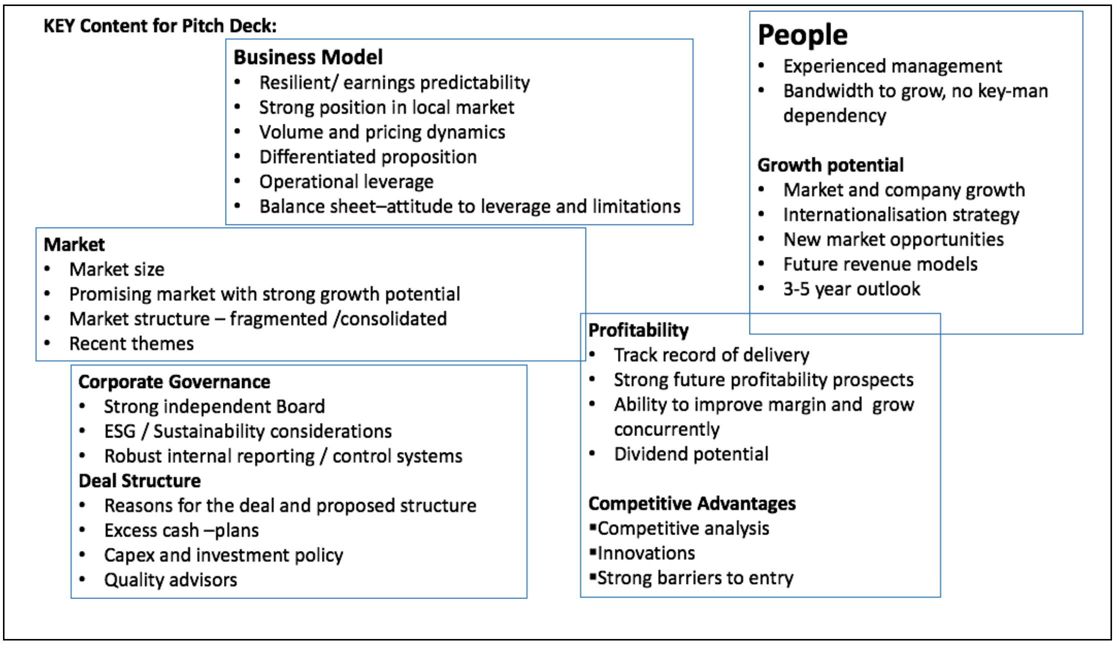
Source: UCD, 2021

SCRAP Model of Storytelling

- Situation: What was situation? This familiarises the listener with who, what, why, where, when and how. Provide concrete detail on situation for credibility.
- Complication: What is the complication? What is not as it should be? What dramatic data proves the case? What has been tried before and has/has not worked? Use metaphor or analogy to make it concrete
- Resolution: What is the potential resolution? What are the priorities? What are key components? How will the complication be resolved? What might be the business impact?
- Action: What do you want listeners to do? What next steps took place in your story?

- Proof: What's in it for the listener? What proof do you have that you are credible? What 'tool' or previous example can you use? Big point is that your company has same challenges & would benefit too.

Figure 2.3.2.2 – Pitching content



Source: UCD, 2021

2.3.3 Investor relations

Investor Relations (**IR**) refers to the responsibility of building trust and managing communication between a company's corporate management and its investors. An Investor Relations Manager helps support releasing information, handling inquiries and meetings, providing feedback to management. The objective of the IR task within a company is to help investors to have a clear picture of company's status and make informed decisions regarding their equity share and the resources they are willing to commit to the company. The IR department does this by providing up-to-date information about the company's operations, financial statement to current and potential shareholders, as well as third-equity research analysis (CFI Education, 2021).

Investor relations activities:

- Data analysis and visualisation
- Financial model creation
- Data collection/preparation
- Investor event preparation
- Networking and communication

- Understanding investors' mindsets

Table 2.3.3.1 Detailed data to be provided at key points to investors:

ACHIEVABLE TARGETS

- Don't go for the J curve!
- Funding sources for the business e.g. through cashflow, debt, new investment
- Robust planning
- Accurate forecasts that can stand up to scrutiny

DEAL TERMS

- More details the better
- Primary vs secondary, who is selling, use of proceeds, management ownership and incentives

WELL DEFINED MEDIUM STRATEGY

- New markets, sectors, products, sales strategies, geographies etc.
- People – growth in management team and staff numbers
- Investment in operations e.g. capital equipment, IT, marketing
- Expansion plans - organic or M&A

SOLID AND TRANSPARENT FINANCIALS

- Clear and easy to interpret

AVENUES FOR GROWTH

- Revenue –growth, market share, new revenue lines
- Profitability –produce mix, operational leverage, cost efficiency
- Capital allocation –acquisitions, capex, dividend policy

THE EQUITY PERSPECTIVE –CAPITAL APPRECIATION

- Why do you want my money?
- R&D or capex; acquisitions, strengthen balance sheet, cash out?
- How is your business different?
- Define how it compares to peers (business model, management credibility, geographic mix, business mix, ESG and alignment of interests)

- Does it fit with my investment style?
- Does it improve my overall portfolio risk/reward?
- Can I credibly put a valuation on it?

3 Preparing for Exits

The third step to raise external capital is: presenting an exit strategy to potential investors.

This chapter explains to entrepreneurs why it is relevant to think of an exit strategy in the early phase of the project, and how to go about it in defining one. Through these insights entrepreneurs will be able to identify potential acquirers and work out the numbers to estimate their exit valuation, a key output for investors to calculate their expected return on investment.

3.1 Exit Strategy

Aims of the chapter:

- To explain to entrepreneurs why it is relevant to think of an exit strategy in the early phase of the project,
- To present do's and don'ts in defining exit strategies
- To show how to select advisors and identify potential acquirers

3.1.1 The Exit strategy

Starting strong is good. Finishing strong is epic. – Robin Sharma

'In Silicon Valley, the most important thing to think about when starting a company is how you're going to end it. The venture capital funding model that dominates the tech industry is focused on the "exit strategy"—the ways funders and founders can cash out their investment'. (Lemley and McCreary, 2019)

<u>What is an exit strategy?</u>

An exit strategy is a conscious plan that a business owner, investor, trader, or venture capitalist implements to liquidate his/her position in a business.

The exit strategy is considered the most difficult and tricky part of venture investment cycle. "A well designed and well executed exit strategy can create as much value as all the other work building shareholder value over the years" (Nick Pearch, 2013)

Why is the exit strategy so important?

Remember, you never make money by buying, only by selling. (Tjan, 2008)

To understand the importance of an exit strategy, it is vital to try to capture the investor's perspective: investors need to build their portfolios toward exits, and thus invest only in companies where they see potential of selling their shares at some point in the future. Only by selling their shares (at a higher value compared to purchasing price) can they monetize and gain their investment, and re-invest the capital in new ventures. Not realizing the exit stops the cycle and prevents investors to keep supporting innovative ideas and entrepreneurs! As such, investors are willing to help their portfolio companies to build relations with other market players, both financial and industrial.

Despite the relevance of exits for the investor, the majority of founders do not outline exit strategies to their investors as they focus on highlighting the value created by their business and by the way they are running it.

Thinking of exits is also beneficial to founders: preparing and pitching the exit, and managing the sales process professionally will almost certainly result in higher valuation and attractiveness. It has been observed that successful startups plan for a comprehensive exit strategy also accounting for eventual unsatisfactory business operations: this reduces the emotional stake of selling the business and reduces the risk of impulsive decision making.

Investors claim that a carefully planned exit strategy should be included in the business plan: ideally, entrepreneurs should develop an exit strategy when drafting the business plan and keep iterating it when needed during the launch and growth phase of the venture. The choice of exit plan will influence business development decisions. (Nick Pearch, 2013)

Most popular types of exit strategies

a. Initial Public Offerings (IPO): First divestment following flotation: the sale or distribution of a private company's shares to the public for the first time by listing the company on the stock exchange. (Invest Europe, 2021)
b. Strategic Acquisitions: The sale of a company's shares to industrial investors. (Invest Europe, 2021)
c. LBO/MBO – company acquired by founders/management using leveraged financing (Pearch, 2013)

d. Secondary financing by private equity firm (development capital): The buyer of the portfolio company is a private equity firm. (Invest Europe, 2021)

The best choice of exit will depend on entrepreneur's motivation, e.g. access to new capital; creating a market for employee shares; enabling financial investors to exit; credibility with customers, etc. (Nick Pearch, 2018)

<u>The people who make the wheel spinning around.</u>

Entrepreneurs need to make sure to have adequate human resources to manage the exit process whilst still running the business.

The exit team should consist of:

i. The CEO
ii. The CFO/FD
iii. An exit advisor
iv. A small committee of the board but still the board has to continue working on the core business
v. A good lawyer (for contractual documentation, once a deal is agreed in principle). This could be your regular company lawyer if (s)he has the right experience.
vi. Investors could be useful team members but are not the ones who should lead the exit process due to different aims than the founder

3.1.2 Stages of building exit strategy

<u>Step 1 Preparatory phase</u> (12-24 months before exit)

Exit is just another fundraising process: the aims to sell the equity to an investor or to an industrial partner that will grow the company further.

This implies pitching the company to a range of actors highlighting the Unique Selling Proposition (USP), how it will create strategic value for the buyer and represent a growth opportunity for the overall business.

You will have to prove your business model is working, the figures achieved in the previous years and how these figures will keep growing – and possibly will grow faster thanks to new shareholders. This can include access to new markets, distribution channels, customer segments, production capacity and more to which the perspective acquirer is exposed.

One important and not intuitive point is to make sure that the CEO is the right person on right place. A CEO should keep taking care of leading the business and making sales. The founder and the CFO may be better suited to plan and execute exits. CEOs and other top management executives may also have conflicting interests in regard to an exit as they risk being replaced by the new shareholder group.

Before getting anything done, check if the Shareholder Agreements include liquidity clauses obliging you to seek an exit within a certain time.

Finally, discuss the possible sale of the business with your major shareholders to understand their aspirations and any timing constraints for their funds. Many institutional funds are obliged to sell their investments within a fixed timeframe. Make sure all the shareholders are aware of your plans and agree with the process.

Do not forget to keep your daily operations organized, i.e. gather documentation on the procedures that drive your business, the minutes of board and shareholder meetings. Check if the key contracts can be renegotiated in case they could block the exit, ensure patents, trademarks and brand names are properly registered and up to date. Take care of your accounting policies so that they are in line with international accounting principles and that your budgeting and financial reporting is of a high standard. The expenses have to be simplified and clean. Only the costs directly linked to the business can show up on the financials.

Step 2 Potential acquirers (12-18 months before exit)

An entrepreneur should answer the following questions on potential acquirers:

- Is any competitor, supplier or customer a potential acquirer?
- Could there be any potential acquirer from outside the market and country the company is operating in? Are they looking for possibilities to enter new markets/countries?
- Are there any synergies between my company and the potential acquirer?
- Are the potential acquirers profitable enough to complete the acquisition?
- How to strengthen the relationships with the potential identified acquirer?

Step 3 Advisors (6-12 months before exit)

An advisor (sometimes called also M&A or financial advisor) is an indispensable guide through the exiting process. Before choosing the right advisor, it is crucial to get to know the roles she/he performs which will help the entrepreneur to visualize the responsibilities of the perfect person to close the deal.

First of all, advisors ensure that the founder/CEO can continue running the business without committing herself totally for the sake of the selling process. Advisors plan and coordinate the selling process. According to Thomas W. Lyons (2008) it is ‘you [that] define what your business is, the advisor communicates it to buyers’. Advisor will also look for potential acquirers and “identify the strategic value of the acquisition to potential buyers and ‘sell’ this value” (Nick Pearch, 2013). Based on the experience, she/he can decide on the best structure for the sale and close the deal.

While choosing the advisor, the following factors need to be taken into account:

- Personal reference for potential advisor, so reach out to your networks.
- Experience in the given sector and a success story behind.
- Getting along well with an advisor is a good starting point for future cooperation, since the exit process will be time-consuming and emotional.
- Engagement contract with the specific tasks you expect them to carry out.
- Resources for paying the exit team need to be foreseen at this stage, so as to avoid any sign of cash constraints. Fees do vary but they usually include remuneration for the preparation period, often paid monthly, followed by a success fee for a completed sale. The success fee, which will normally be a percentage of the sale but subject to a minimum fee, should be the most important part of the total fee.

3.2 Exit figures

Chapter objectives:

- To explain the fundamentals of startup valuation;
- To show the main valuation drivers in a company and how to achieve the highest price;

3.2.1 Valuation overview

When evaluating a business investors look at a number of factors regarding the company’s conditions and context. Despite not being the only one indicator of success, financial projects are object of rigorous scrutiny as they ensure that the return for investors will reflect the risk they are taking. Therefore, all valuation methods require financial figures and assumptions on future financial performance to some extent.

There are many ways of approaching this task, such as IRR, DCF, multiples. Common elements of these methods (and fundamental elements in finance) are that the time value of money and the level of risk are used for discounting future returns: the higher the perceived risk of failure, the higher return expected for success and the higher discount factor should be applied to reflect the uncertainty of future returns.

Most investments ultimately come down to a judgement about risk vs return: despite investors and entrepreneurs can work together on figuring out the right growth rates, cost structures, investments, and so on, it should be noted that financial projects are based more on hope than reality, and may need to be adjusted to reflect more prudent assumptions.

The further out the projections, the less reliable they become: entrepreneurs should be weary of being overly optimistic about their prospects – despite this confidence being essential for success, their ambitious targets are rarely achieved in practice.

It is said that a good business is one that achieves its year 1 targets in year 2. So one way of building scenarios for over-ambitious projections might be simply to assume that the sales and profit targets are achieved one year later than forecasted, or alternatively to apply a percentage reduction to the revenue numbers.

Investors and entrepreneurs should be comfortable with the assumptions of the business plan, however they should both beware of putting too much reliance on the financial evaluation: A good idea in an attractive market with strong barriers to entry and a competent and focused management team are ultimately more important indicators of likely success.

A good practice is to show different scenarios: a pessimistic one, a base case and an optimistic one.

3.2.2 Valuation Principles

There is only one way to accurately value a business – sell it!

Projecting a company's performance into the future implies relying on a set of expectations regarding the overall market, the given industry, the riskiness of the technology, the acceptance of the product service, the resilience of the management team, the evolution of the competition, and other factors. Obviously, each entrepreneur and investor will have different assumptions on these factors, leading to different estimates of the value of a company.

Because of its subjectivity, the final valuation amount is object of negotiation between the investor and the founders, and soft skills are a key weapon in closing the deal, refer to section 2.3.3 Investor Relations for more details on how to handle relationships with prospective investors.

There are various ways to determine the value of a startup. The methods most widely used by angel investors and venture capitalists are Multiples, DCF, or Comparable Transaction.

To finalize the valuation of the business, investors will ask several documents regarding the team, technology, financials. All these documents have been listed in the previous chapter of this Toolkit.

Multiples valuation

The multiples valuation starts from the concept that similar assets sell at similar prices. Thus, if you can identify similar assets, find their market value, make them standardized through multipliers and compare this standardized value to the target's assets, you will be able to give a value to your target.

There are 4 steps in the Multiples methodology:

i. Define the multiple: how did you estimate the multiple?

There are different multiples that can be used. The 2 that are most common are: EV/EBITDA and P/E.

EV/EBITDA is calculated for each comparable taking their Enterprise Value (that can be found on Yahoo! Finance in the "Statistics" tab) and dividing it by its EBITDA (that can be found on Yahoo! Finance in the "Financials" tab – Income Statement). The ratio is already reported on Yahoo! Finance in the "Statistics" tab.

P/E is calculated for each comparable taking their Share Price (that can be found on Yahoo! Finance in the "Summary" tab) and dividing it by Earnings per share (that can be found on Yahoo! Finance in the "Summary" tab). The ratio is already reported on Yahoo! Finance in the "Statistics" tab.

Once all the multiples of the comparables are collected, it is possible to calculate the multiple to use doing an average, better a geometric average, but it depends on the cases.

ii. Describe the multiple: what nature is the multiple of? Is it an equity-side or asset-side multiple?

The difference relies in the formula:

Equity (market) value = Enterprise Value - Debt (market) value

If the multiple is asset side (derives, eg, from EBIT or FCFO), the result will be Enterprise Value (EV). If the multiple is equity side (derives, eg, from Net income, EPS or FCFE), the result will be Equity Value. As an example, EV/EBITDA is asset side, P/E is equity side.

iii. Analyse the multiple: which variables affect the multiple?

As an example, P/E is related to the growth of a company, its risk and its cashflows. EV/EBITDA depends on the cost of capital, growth, tax rate and reinvestment rate.

iv. Apply the multiple: what are the peculiarities of the companies considered?

The multiple can be applied in different ways. There could be direct comparison, if the comparables are really similar. Or, the multiple could be adjusted on the basis of certain considerations.

To find the value of the company it will then be necessary to multiply the multiple by the company's specific values. In particular, EV/EBITDA needs to be multiplied by the EBITDA of the target, while P/E by the Net Income of the target. Remember that the former gives Enterprise Value and the latter Equity Value and the investors want the Equity value.

To estimate the EBITDA and Net Income, companies should draw financial projections of their revenue and operating costs. For guidance on how to forecast and build a financial model, refer to section 1.1.3. Financial Planning.

Discounted value of future cash flows (DCF)

In the DCF method the value of the company equals the sum of future cash flows discounted at an appropriate rate.

$$DCF = \frac{Cash\ flow_{t1}}{(1+r)} + \frac{Cash\ flow_{t2}}{(1+r)^2} + \cdots + \frac{Cash\ flow_{t}}{(1+r)^t}$$

The **discount factor** (**r**) reflects the level of riskiness of the business, and can generally be estimated at *20%* for high risk; *15%* for medium risk; and *10%* for low risk. These discounted cash flows are cumulated and represent the present value of the cash flow generated by the company for the owners (Miciuła, Kadłubek, & Stępień, 2020).

To determine the Cash flows, industry-specific and company-specific growth rates are used. These ratios are calculated based on key drivers of performance for the given industry and the given company and thus give insights on how fast a business is growing and how much it can be expected to grow in the future. Some examples are *monthly unique visitors* or *average order value* for websites, e-commerce and marketplaces; *occupancy ratio* for hoteling and entertainment, *capital adequacy ratio* and *monetary reserve* for banking, *sales per square foot* for retailers, or *revenue per employee* for service companies.

Comparable Transactions Method

In some cases, investors define the value of companies based on a benchmark. **Benchmarks** are comparable companies that have been acquired recently, therefore their acquisition price gives an idea of the willingness to pay and expectations of investors.

4 Final considerations

Now that you arrived at the end of the Toolkit, we expect you to be ready to fundraise or give advices on fundraising.

Some last tips from Successful Entrepreneurs for Successful Fundraising:

- Be realistic about Valuation
- Be realistic about how long the process will take
- Build sensitivity into your cash flow plan.
- RUN Fundraising as a Process
- RESEARCH your investors – know their green lights and red lights
- BE PREPARED – have all your investor documents ready.
- ENGAGE with a good corporate lawyer – ensure the company is structured correctly
- Be Resilient

In Annex II, you will find additional material that can provide further help.

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Annex I: Glossary of usual acronyms

AIFM	Alternative Investment Fund Managers
AMC	Asset Management Company
CEF	Closed-End Fund(s)
CFt	Cash Flow at time "t"
CG deals	Corporate Governance Deals
D/E	Debt-to-Equity
DCF	Discounted Cash Flow
EBIT	Earnings Before Interest and Taxes
EBITDA	Earnings before interest, taxes, Depreciation **and** Amortization
EBT	Earnings Before Taxes
EV	Enterprise Value
EVCA	European Venture Capital Association
GPs	General Partners
IPO	Initial Public Offering
IRR	Internal Rate of Return
LBO	Leverage Buyout
LLP	Limited Liability Partnership
LP	Limited Partnership
LPA	Limited Partnership Agreement
LPs	Limited Partners
M&A	Merger(s) and Acquisition(s)
NFP	Net Financial Position
PE	Private Equity
PEI	Private Equity Investor(s)
PEX	Participation Exemption
PIPE	Private Investment in Public Equity
PPP	Public-Private Partnerships
QSBS	Qualified Small Business Stock
SA	surplus (non-operating) assets
SBIC	Small Business Investment Companies
SMEs	Small-Medium Enterprises
SPACs	Special Purpose Acquisition Companies
SPV	Special Purpose Vehicle
TV	Terminal Value
VBC	Venture-Backed Company
VC	Venture Capital
VCF	Venture Capital Funds

VCM	Venture Capital Method
VCT	Venture Capital Trusts
WACC	Weighted Average Cost of Capital

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1.1.1 Team and Governance

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