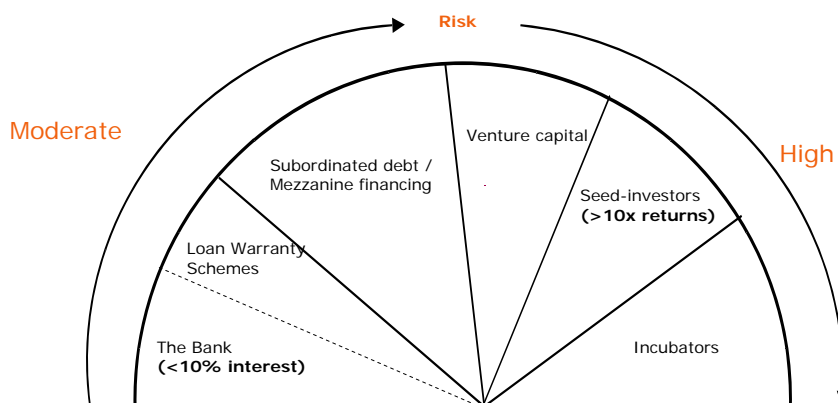


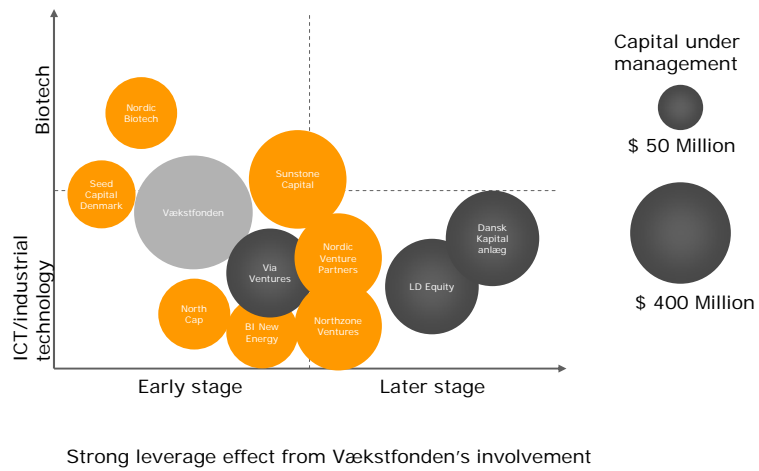
# THE ROLE OF RISK CAPITAL

Frank Knudsen, Investment Director, SEED Capital Denmark

Cost of capital is directly linked to the risk



## The Danish Venture Market



Vækstfonden

## The players...

- Incubators ("Innovationsmiljøer") 6
- Business Angels 200+
- Venture Capital firms 2-4 with money
- Vækstfonden 1

Vækstfonden

“SEED Capital is the largest early stage venture fund in Denmark.

We assist competent entrepreneurs in developing ICT, life science and clean technological companies from pre-seed to tradesales and IPO's. We invest in Denmark and South Sweden.”



- Established in December 2004.
- DKK 1 billion under management.
- Nearly DKK 2 billion external funding to portfolio.
- DKK 1.5-4.0 million pre-seed.
- Up to DKK 50 million in seed funding.
- +65 companies in portfolio.
- 6 exits, 1 IPO.
- 11 investment professionals.

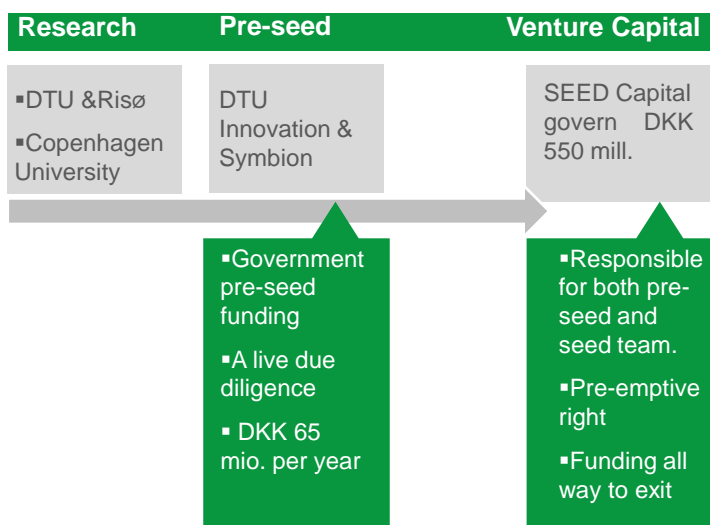


## A Year In Brief

- 300 ideas screened
- 60 ideas result in meetings
- 10-12 new investments
- Initial investment usually DKK 1,5-2 mill.
- Follow-up investments: Approx. DKK 7,0-7,5 mill.
- Attracts DKK 300-500 mill. from external investors



## A strategic secured deal flow



## Investment Criteria

- SEED Capital invests in highly scalable business opportunities with a significant growth potential.
- Technologies must meet a real need in an attractive and potentially large market.
- The initial management team of the seed stage venture is more technical essential. SEED will assist in finding strong commercial management when technical proof has been achieved.
- After 12 months the team has to involve people with entrepreneurial spirit and skills as well as relevant and well-documented professional qualifications.
- Founders and management will have to bring together complementary skills in order to succeed in building a high tech venture company.



## Due Dilligence

### Technical

- Can it be done?
- Can it be done for the expected price and within the time?
- What are the risks?

### Commercial

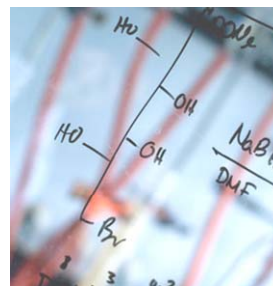
- Is there a market?
- Can it be reached?
- Is it profitable?
- Is it scalable?

### Legal

- Who owns the rights?
- Can we expect strong patents?
- Is there freedom-to-operate?

### Organizational

- Is the team capable of reaching expectations?
- Need/can/will it be strengthened?



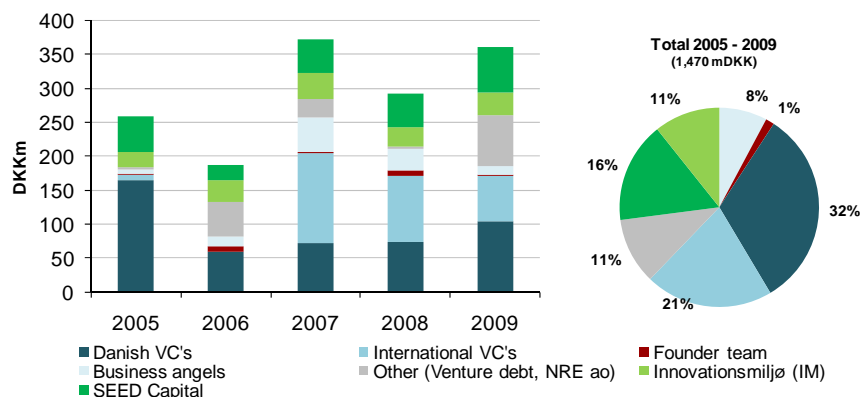
## Investment Fundamentals

- Investments made into established limited companies (ApS or A/S)
- Minority ownership
- Majority usually owned by founders
- All patents are owned by the company
- No demand for security (unlike banks)



## Funding in 2005-2009

Funding to SEED companies of DKK 1.5 bn \*



\* Note: Additional 1 bn DKK funding to non-SEED portfolio companies



## Taking a portfolio approach

Individual Event	Probability
Company has sufficient capital	80%
Management is capable	80%
Product development follows plan	80%
Production follows plan	80%
Competitors behaves as expected	80%
Customers want product	80%
Pricing fits market	80%
Patents are issued and enforced	80%
<b>Combined probability of success</b>	<b>17%</b>

If probability of one parameter drops to 50% the combined probability drops to 10% and there are more success factors out there

## Enabling the venture...

100% of a small pie



20% of a large pie



## Typical Entrepreneur mistakes...

1. Overoptimistic about attractiveness of idea – don't research
2. Overestimate how many will buy the solution
3. Underestimate entry barriers
4. Underestimate capital need, cost and timing of capital need
5. Has no plan B
6. Lack of focus
7. Hire the wrong people
8. Lack of focus on EBITDA
9. Seek confirmation rather than the truth
10. Complicated vision
11. Lacks exit strategy

SVASE

VC's prefer A-teams with second class ideas over B-teams with first class ideas

It is all about execution



## The Ideal Entrepreneur - Is a team



## The Google Team – Technical and Commercial Masterminds



However the perfect entrepreneurs don't always look great

Would you have invested?



Microsoft Corporation, 1978

## The Process

### Due Dilligence

- Thoroughly Investigate the opportunity
- Technical, Legal, Team, Market etc.

### Syndication

- Invest together with others
- Reduce Risk

### Specialization

- Know the field in-depth

### Localized Investments

- Be close to the investment

## Contractual...

### Ownership

- Minority stake: 20-40%

### Invest in Tranches

- Milestone based payments (staged financing)
- Similarities to real options

### Liquidity Preference

- Downside protection – gives preference over common stock and simulates debt
- Catch-up, Hurdle rate

### Material Decisions

- The VC invest in own class of shares and major decisions must be approved by owners of this class of share

### Drag Along

- The VC can force all other shareholders to sell their shares often at any price

### Key Man Clauses

- The management team is all important – this is where the VC tries to make it difficult for them to leave

### Anti Dilution

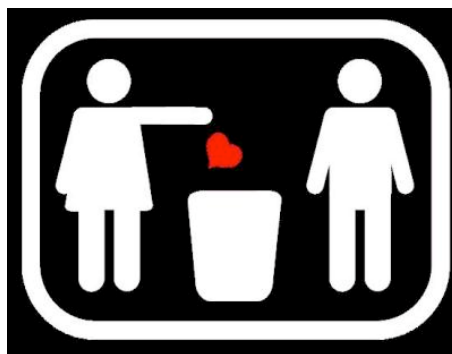
- In the case where the company needs to raise money at very low valuations the VC receives new shares to maintain their equity ownership – Assymmetric information

### Warranties

- Founders are held responsible for telling the truth before investment has been made

## VC deal making

It is like dating and marriage



You don't close the deal after first date

## Key Problem – Missing link between business plan and financial plan



If my company is expecting to have this much revenue – then what is my plan to get there?

If my plan is this – then what is the likely revenue, cost and capital requirement



...**clarify** to yourself and potential investors what the **assumptions for the budget** are in relation to revenue drivers, cost drivers, investments etc.

It is always **better** to make **informed and reasonable assumptions** than **claiming it is difficult to predict the future**

Think contingent scenarios

- **Base line**
- Worst Case

As well as using WHAT IF? Scenarios on important parameters – Revenue, Price, COGS, Funding...

### Landscape for early stage companies

SEED  
CAPITAL

Challenges

- Capital intensity: \$30-50 million to ask the question (even then, you may not get the answer)
- De-risking transformational IP (more later) is inherently risky
- Challenging to get fair value for pre-clinical candidates
- Pharma focused on later stage acquisitions
- Financing environment tough

Opportunities

- Externalisation is fashionable among pharma R&D (50% target at GSK)
- Tend not to be binary outcomes (investors like this)
- Demand for innovation high?
- Demand for product even higher?

## Does pharma pay fair value for early assets?

- AstraZeneca 2009 accounts:

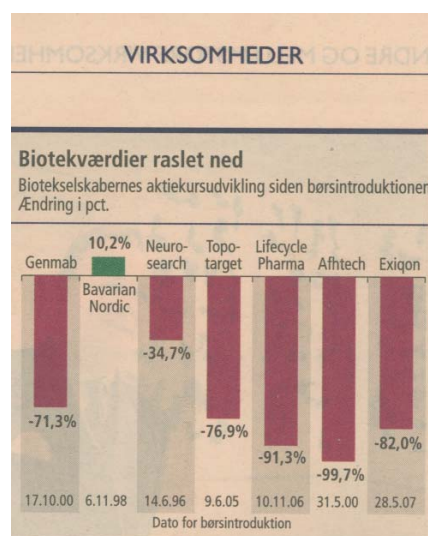
- R&D spend: \$4.4 billion
- Discovery: 25% = \$1.1 billion
- Pre-clinical candidates: 29
- Assumed back-ups: 50%
- Commercial attrition: 12.5%
- Novel PCCs: 11

- Cost per novel PCC: \$100 million (cash cost)

- Would a small biotech company get such a deal?

- \$20 million upfront, \$80-100 million in milestones, 6-10% in royalties
- NPV of this cash stream: \$35 million
- .... After rigorous due diligence process

## Is an IPO the best solution?



## Alternatives for early stage companies

- Fully fledged company

- \$30-60 million budget
- Own premises and labs
- 30-50 employees/FTEs
- Capability development

- Can pre-clinical/early clinical exit be achieved?
- Can exit value of min. \$250 million be achieved?

- Virtual company

- \$10-20 million budget
- Office
- 2-10 employees/FTEs
- Asset development

- Exit assumption – clinical or pre-clinical
- Can exit value of min. \$100 million be achieved?

- Non-dilutive capital

- R&D grants (industry, charity, military)
- Service business

- Significant capital base required
- Consortia building/IPR issues

## Valuation basics

..... IRR, Return Multiple, Absolute Return,  
Ownership under the different deal terms...

... the case from an overall perspective (team,  
industry, technology, etc)...

However most often the price of a company  
comes down to negotiation over a cup of coffee

Any Questions?

