Venture Funding for the University Startup

India Vincent, JD, and April McKenzie Mason, MBA, JD

India Vincent, JD, is a partner in the intellectual property and corporate practice groups of Burr & Forman LLP in Birmingham, Alabama. April McKenzie Mason, MBA, JD, is also a member of Burr & Forman's corporate practice group.

Universities have long-served as the breeding ground for innovative technology and research. For that reason, university-developed technology has often been an attractive target for venture capital funding. Such venture funding has aided in the successful commercialization of select intellectual property developed by entrepreneurial-minded university faculty and students. Without this financial assistance, the technology may still be considered a great academic accomplishment for the university but may never develop into a successful business for its inventors.

This chapter is aimed at helping technology transfer offices (TTOs) and entrepreneurial faculty and students understand the role of venture funding for university startups. It will first explain the sources, stages, and strategies for venture funding. It is also designed to provide insight into how to attract investors and how to manage investors' expectations. Finally, this chapter will provide guidance on how your university can support entrepreneurship and foster an innovative culture that attracts venture funding for its startups.

Startup or License?

Not all technologies coming out of universities are appropriate to spin off into startup companies. It is important for TTOs to recognize which technologies should seek venture funding and which are more appropriate for licensing transactions. Technology that results in a range of products for a variety of new markets are the most suitable for venture backing. Technology that simply builds on existing products, markets, or customers is often more suitable for licensing.

In addition, if the startup costs are high, and the founders have insufficient resources and experience to see their idea to market, licensing to a well-established and integrated company may be a more practical approach. Therefore, you should first analyze whether your technology is suitable for a startup before seeking venture capital. This will save both you and your prospective investors time and effort and will add credibility to your TTO.

What Is Venture Capital?

Venture capital is a type of private equity investment. Private equity investments are, as the name indicates, investments in private companies and are generally not available to the public. These investments are made with the expectation of a high rate of return for its investors through a realization event such as an initial public offering (IPO) or the sale of the company.

Venture capital is generally provided to early-stage companies with a high potential for growth. Most venture capital investments are made in high-technology sectors, such as bioscience and software development. Since these investments are made in the early stages of a company's lifecycle, they can be risky investments. For that reason, venture capital investors demand higher rates of return for their investment. The goal of a venture capital investment is to identify unique technologies at an early stage that have the potential to generate high investment returns quickly.

Sources of Venture Capital Funding

There are several sources of venture capital funding. When seeking funding from these different sources, you should understand the investor's investment objectives, as well as the advantages and disadvantages of seeking capital from a particular source.

Friends and Family

Friends and family may be your only viable source of funding in the early-development stages of your technology. Investments from friends and family are also the easiest to secure. You already have a personal relationship with these sources, and their objective (at least initially) is more aligned with helping their friend or family member rather than seeking a rapid and significant return on investment. When friends or family members invest, they are usually not thinking about their exit strategy and they are less concerned about the valuation of the startup. The pre-money valuation of a startup (the valuation of the company prior to the investment) is more important to venture capital (VC) funds because it correlates directly to the amount of equity an investor may receive in the startup. Although friends and family may seem like the easiest source of funding, it probably is the source with the most disadvantages. Everyone has been advised at some point that it is not good to mix personal matters with business. This certainly holds true when it comes to seeking funding for a startup. In addition, friends and family will generally not be able to provide the same business advice and managerial experience that you usually are able to obtain from other sources of funding such as VC funds. Finally, friends and family may not qualify as accredited investors. To be classified as an accredited investor, a person's assets or salary must exceed a certain threshold. If the friend or family member does not qualify as an accredited investor, an investment from such friend or family member may result in a violation of state or federal securities laws.

Angel Investors (Individuals and Syndicates)

Angel investors are wealthy individuals (that qualify as accredited investors) who are looking to invest in startup companies. These investments often range from $100,000 to $1 million early in a startup's lifecycle (although the investment can be less or more depending on the particular technology and capital needs of the startup) and can often serve as bridge funding until the startup company is at a stage where it may seek funding from a VC fund. A startup may seek capital from individual angel investors or may approach an angel syndicate. An angel syndicate is a network of angel investors within a particular community.

Angel investors can be a great source of contacts and advice since they are usually very connected within the business community and generally have been successful with their own business ventures. However, be aware that angel investors are more concerned with an exit strategy than a typical friend or family member. This exit strategy is a mechanism for liquidating their investment quickly and with a substantial return. They will also be more sensitive to valuation issues than friends and family. Deal terms with angel investors vary from angel to angel depending on the angel's comfort level with the deal and his or her risk tolerance. There are not as many standard requirements from angel investors as you may see from VC funds.

Seed Financing Companies

Seed financing companies are similar to angel investors, however, they approach the investment process like a business. Like angels, their investments are generally smaller and during the very early stage of a company's lifecycle. In addition, they can serve as bridge funding until the startup is ready to seek funding from VC funds. For that reason, seed financing companies will usually offer advice on how to market your startup to VC funds.

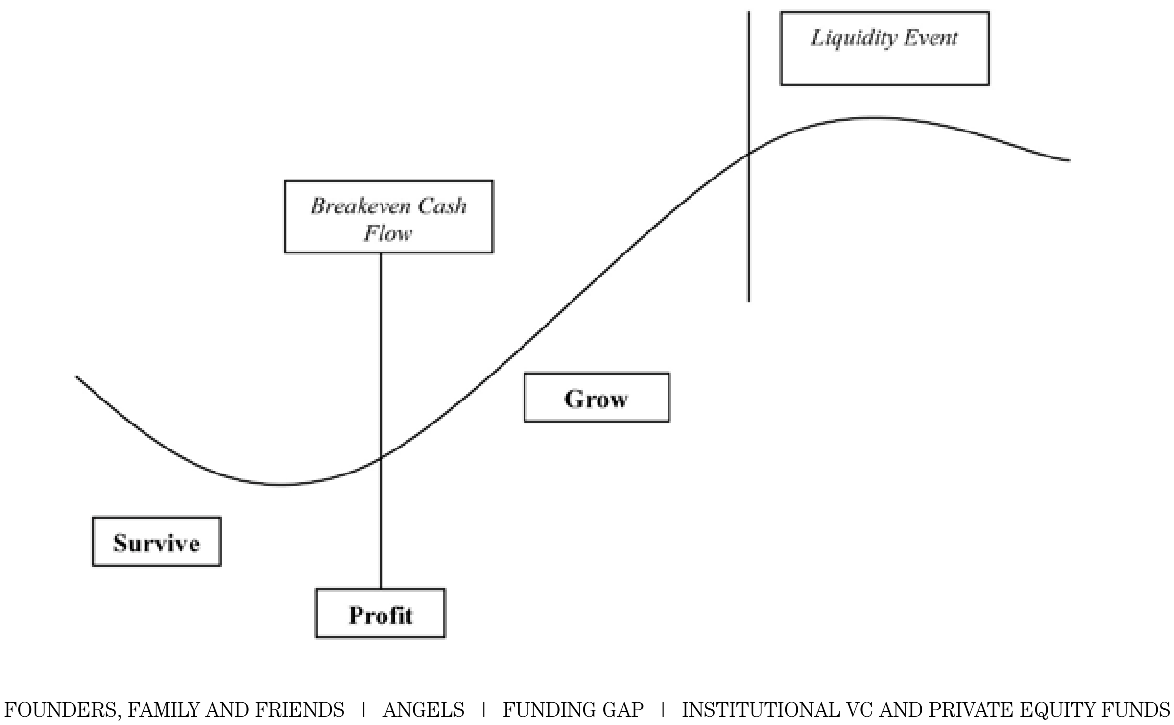
Venture Capital Funds

It is critical to understand what a VC fund is so you understand its goals and objectives. A VC fund is a pool of private equity used to grow new businesses. A fund is generally comprised of a general partner and limited partners. The general partner makes all the decisions about where to invest this pool of capital and owes a fiduciary duty to its limited partners. The limited partners are the individuals or entities making the contributions of capital to the fund. VC funds have a fixed lifespan and are generally seeking an above-market return on their investments.

A startup should consider a VC fund's three main investment criteria when marketing its business to such fund. These are survivability, profitability, and growth. First, the startup must have a product or service idea that can survive competition. As a result, VC funds generally want to invest in startups that have patent or patent-pending technology. This will prevent other more established companies with more resources from competing with the startup (and possibly stealing all of the startup's potential customers).

Second, the startup must show profitability. Before a VC fund will invest, it generally likes to see that a startup has achieved breakeven cash flow on a sustainable level. Ultimately, VC funds want to be assured that they are investing in a company that will provide an above-rate return on its investment. Finally, VC funds are looking for investment opportunities that are high growth. Startups that tap into a large and rapidly growing market are ideal investments for VC funds. VC funds want to invest in companies where they can see a clear and identifiable exit strategy in sight (approximately two to five years). High-growth markets provide for this clear exit strategy.

LIFECYCLE OF A STARTUP



Investment from a VC fund can instantly add credibility to a startup company. In addition, it can offer professional management services and business advice that can help a startup achieve a liquidity event. This advice can be critical to the success of a startup. However, you should be aware that you may get this advice whether you want it or not. An investment by a VC fund is usually conditioned on the startup relinquishing certain control of the company to the fund. This is justified because the VC fund is generally willing to make a larger investment in the company than some other sources of funding. Lower tier firms may provide better terms because they need more companies in their portfolio, but they will not offer as much credibility as some of the more successful funds. In general, however, most VC funds are much more sensitive to valuation issues than friends, family, and angel investors.

Stages of Funding

At the beginning of a startup's lifecycle, the founders may need capital to develop the business, but the company might not be at the stage yet where it can successfully solicit funding from a VC fund. During this initial or seed round, startups may turn to friends and family for funding. At this stage, the startup has just enough money to survive until it can get funding from an angel investor or seed financing company.

By the angel round, the startup has developed a business plan and may be able to demonstrate its product, rather than just describe an idea. During this round, the startup focuses on developing its business so that it can get to a stage to seek additional funding from a VC fund. These early-stage investments can be critical for sustaining a startup until it is ready to seek funding from a VC fund. Between the angel round and the venture round, there is generally a funding gap. The startup can spend this time to work on its image and other intangibles that require minimal capital expenditures.

During the venture round, it is not unusual for the startup to receive funding in several different series. Many funds are wary of giving all of their investment at once due to the risky nature of the investment. Therefore, they may give funding in various series after certain milestones are met by the startup.

It should be noted that a startup does not necessarily have to go through all of these stages of funding, but may actually skip a round depending on the technology and the product market. Additionally, government grants and funding can also serve as an important source of initial funding and may replace one or more of the rounds discussed above. Grants are a welcomed source of capital by any investor because there is no expectation from the government to receive any equity in the company and, thus, this funding does not dilute any previous investments.

Exit Strategy

A VC investor's primary concern at the time of investment is how and when it will receive a return on its investment. At the moment the initial investment is made, the VC is already thinking about an exit strategy or liquidity event. The goal is to receive its investment back with the highest rate of return and in the shortest amount of time possible.

There are four main types of exit strategies discussed below, each offering different advantages and levels of risk for the investors and the startup.

Industry Collaboration

Universities have become a critical source of research and development for many innovative industries. More and more large companies are building strategic alliances with universities to help develop and deliver products to market faster. These strategic relationships include licensing arrangements, corporate-sponsored research or grants, and VC investments. Although industry collaborations are becoming more and more popular, they are not seen as frequently in some areas, such as the biotechnology sector.

Industry collaborations provide significant opportunities for university-developed technology. First, the corporate partner is making more than an investment, it is developing a strategic partnership. In addition to funding, the industry partner can also provide the startup access to its own research and development (R&D) as well as product and market knowledge. Since industry investors have a direct interest in the technology being developed, they often times can serve as the best avenue for commercializing university-based technology. This benefits industry investors as well because it can provide them with early access to new technologies and lowers their R&D costs.

Licensing Agreement

A licensing agreement serves as a partial exit strategy. It is an agreement between the startup and an interested strategic partner, whereby the strategic partner licenses the startup's technology from the startup for a certain period of time in exchange for a royalty payment. Generally this includes a substantial initial licensing fee, as well as ongoing royalty payments.

With a licensing agreement, the startup will continue to own the technology (although it may have licensed away its right to use the technology temporarily). It allows a startup to ensure a long-term source of revenue, but it does not necessarily create an opportunity for the equity owners to completely cash out their investment. Note, however, that in some instances, the initial license fee is enough to allow certain investors to exit the venture. As discussed earlier in this chapter, some technology is more suitable for licensing rather than an IPO or acquisition.

Acquisition

Often times VC firms invest in university startups with the thought that they will be able to make a return on their investment when the startup is in a position to sell or merge with another company. As opposed to a licensing arrangement where the startup (and investors) will receive royalty payments over a long period of time, an acquisition results in a lump sum payment to the founders and investors. Larger companies looking for a new product usually are the most interested in acquiring a startup company, although private equity funds looking for portfolio companies for their fund may also be potential purchasers.

Finding a strategic buyer is usually the best exit strategy. A strategic buyer is purchasing a startup for the purpose of adding a new product or building on existing products, rather that buying for investment purposes. For that reason, strategic buyers generally provide the best valuation for the company because they are willing to pay more for the good will they will be receiving from the startup's business.

One of the most important factors that helps drive up the valuation of a company is the company's current accomplishments. Has it developed a product yet, and if so, how far along is it in its progress? Are there paying customers? If so, what are the company's revenues? Another valuation driver is the long-term potential of the business. If there is a large market for the startup's product and the intellectual property can be protected to prevent others from easily entering the market, the valuation of the company will increase. In addition to the factors above, a strong management team will also contribute as a valuation driver.

IPO

An initial public offering, more commonly known as an IPO, is the most glamorous of the exit strategies, but it is the strategy with the largest amount of risk, particularly in a depressed economic climate. An IPO is when a company issues common stock or shares in its company to the public. IPOs have the potential of bringing the highest return to investors, but can be risky because of the difficulty of predicting the valuation of the shares on the initial trading day and other external uncontrollable factors (e.g., terrorist attack or natural disaster). Additionally, in a declining economy, it can be difficult to find a buyer or underwriter for these shares. An IPO can offer the most liquidity for investors, however, because the shares can be easily resold on the open market.

Finding Venture Funding

There is plenty of venture funding available to university entrepreneurs. The key is knowing where to look and to know what VC investors are looking for. Below are some tips for attracting VC funding for your university.

Be Visible

Before a TTO can assist its university entrepreneurs in finding funding for their startups, the TTO must make itself visible in the VC community. It is critical that individuals within the TTO develop personal relationships with angels and VC fims. These investors are more likely to fund companies that have been introduced to them through a personal contact, rather than to a startup that has sent its business plan out blindly to all potential investors within a 300-mile radius.

One of the easiest ways to become visible within the venture community is to attend venture forums and participate in community venture clubs. Local, regional, and national venture forums provide a platform for early-stage companies to gather and showcase their business to various angel investors, seed financing companies, and VC funds. This also provides an opportunity for TTO personnel to develop relationships with these potential investors. Additionally, many cities have venture clubs comprised of business professionals who share a common goal of increasing the amount of venture-backed activity within their community. These venture clubs provide various opportunities for TTO personnel to interact with the key players in the local VC community.

TTOs should also encourage their university entrepreneurs to become active in the local venture community. Many communities sponsor business-plan competitions that provide a platform for early-stage companies to compete for a cash prize that can serve as an initial source of funding. These competitions are often attended or even judged by local angels and VC investors and provide great exposure for aspiring university entrepreneurs. Additionally, it is not unusual for the winner of the competition to receive additional funding from a VC fund in attendance. Therefore, it definitely pays (literally) to participate in these competitions. Some universities may choose to go one step further and actually sponsor or serve as a host for a competition.

Know What Your Investors Want (Survivability, Profitability, Growth)

In addition to becoming visible within the venture community, it is essential that a TTO understands what prospective investors expect in a startup investment. In general, investors are looking for companies that can show a clear and quick path to commercialization in a high-growth market. They want a higher than average return on their investment, and they want to invest in a company that is sustainable with protectable intellectual property.

Biotechnology and other high-technology businesses, such as software, generally are the most attractive to VC investors because they have high-growth markets. Software and technology usually require smaller investments and are fairly fast to market. Startups in the life sciences and biotech industry generally take longer to mature due to higher degrees of regulatory scrutiny and, therefore, go through several rounds of financing.

In addition to looking for technology with high-growth potential and the ability to move to market quickly, investors are generally looking for unique innovations that do not require extensive capital. A strong management team is preferred. VCs are also looking for a strong intellectual property position that can serve as a barrier to other potential competitors entering the market.

All of these features must be conveyed clearly and concisely by the startup in a realistic business plan. The business plan should explain the need for the startup's product as well as identify a clear path for establishing market share. The plan should also be drafted and packaged in a VC-friendly manner, with less scientific and more business terms. If an investor cannot understand the business from reading the business plan, it certainly will not take the investment risk.

Selecting the Right Venture Fund

In some instances, a startup will have the fortunate opportunity of choosing among several potential VC investors. Even if your startup has only one suitor, it is essential that you select the right fund to work with your business. A VC fund is more than an investor; it is your business partner. Therefore, the following factors should be considered when selecting a fund:

1. What stage in a product's lifecycle does the VC fund generally choose for investment? Is your business in that stage?
2. Does the fund have expertise in your industry? VC funds can often provide technical and business advice that can be extremely useful to a startup. As a result, expertise in the industry can be critical.
3. What is your position in the fund's portfolio? Are you a small investment, or do you make up a large portion of the fund's portfolio? Funds that invest in your startup's competitors should be avoided. Ultimately, you want your startup to be the most important investment in a fund's portfolio, but at the very least, you do not want to have to compete with a competitor for your VC fund's attention. Competition should be left to the marketplace.
4. Does the VC fund have strong financials and industry contacts? An investment from a credible and financially stable VC fund is an automatic stamp of approval and will assist the startup in seeking additional funding and securing its exit strategy.
5. How much control does the VC fund want over your company? As discussed more in the next section, VC firms will rarely invest without receiving certain management rights in return. Entrepreneurs should consider how much control they are willing to relinquish when choosing a VC fund.
6. Will this VC fund make a good business partner? A VC investor is more than a source of funds; that investor is your business partner. Therefore, entrepreneurs should consider whether they are comfortable with a long-term business relationship with this investor. If you do not trust the VC investor, it will not make a good business partner.

The Deal

Investor Expectations

Once a startup has located a VC partner, it will need to negotiate the terms of the investment with that partner. Founders should have a general understanding of investor expectations before they begin this negotiation process.

Company Management

Often times founders are eagerly willing to accept funding for their startup, but are not so eager to relinquish control of their company. VC funds rarely contribute capital without receiving certain management rights in the company in return. Generally, the VC fund will want the founders to continue working for the company, but it is not unusual for the investor to want to bring in some of its own management team. The VC fund may even demand to fill the chief executive officer position with someone other than a founder.

Losing control over their creation is often difficult for many founders to handle. The founders must realize, however, that a VC fund will be unwilling to provide funding and then watch its investment dwindle away due to poor management. VC funds believe that the founders' strength rests mainly with the product technology, whereas the VC fund has the business experience to manage the company and bring the product to market.

The expectations of both the VC investors and the founders should be addressed upfront. The founders should expect to give up some control of their company. In most cases this is beneficial to the startup because of the business and management skills that the VC firms can offer to an early-stage company. The founders should also recognize their threshold for relinquishing control. If the VC funder wants more than it is willing to give, it might be time to search for another investor. TTOs should help educate their entrepreneurs on investors' expectations as they relate to control so that they are prepared to address this issue when it arises.

Preferred Stock

In almost every transaction, the VC firm asks for certain rights and preferences over the other stockholders in the company. It primarily wants to ensure that it can recoup its investment (and any premium) before the other stockholders. Therefore, VC investors generally ask for preferred stock in the startup. Some rights that preferred stockholders have over common stockholders include liquidation preferences (if the company is liquidated, the VC investor gets paid first and will receive a preferred return before the other stockholders), preferred distributions (the VC funder might receive dividends at a higher rate and before common stockholders), and antidilution rights (if additional shares are issued, the preferred stockholder will automatically be issued new shares so its ownership is not diluted). The preferred stockholders may also have voting rights that are superior to the rights of the common stockholders.

Preferred stock may be convertible as well. At the option of the holders, they may convert the preferred stock to common stock at any time. However, generally the preferred stockholders will have no incentive to give up preferred rights and convert the stock until an IPO. When the company consummates an IPO that meets certain minimum size and share price requirements, the preferred stock will then automatically convert to common stock.

Board of Directors

In conjunction with the VC funder's desire to maintain some control over the startup, it will often secure a seat (or a few seats) on the board of directors of the company. The number of seats granted to the VC firm is generally commensurate with the VC investor's ownership percentage in the startup. This is usually accomplished through a stockholders' agreement whereby the stockholders agree to vote a certain way to secure the VC firm's board positions. It varies among investors whether they want actual control over the board.

Vesting Shares for Founders

In some instances, the VC firm may want to impose vesting requirements on the founders' shares. This means that the founders' ownership in the company will vest over a certain period of time. For example, the VC investor might implement a vesting schedule whereby 25 percent of the founders' shares vest each year over a four-year period, at which point they will be fully vested. These shares often automatically vest upon a certain trigger event, such as the closing of the sale of the company.

Vesting shares demonstrate to the VC funders that the founders are committed to the company. It also ensures that co-founders that leave the business early do not receive the same rewards as the founders who stay with the company. Some VC firms will ask the founders to trade in their current shares for vesting shares. This is a negotiable item. A compromise would be to give the founder vested shares for time already served to the company and create a vesting schedule for its shares going forward.

Closing the Deal Quickly

Time kills deals. This is a familiar saying in the business world and certainly holds true for university startups seeking venture funding. The longer a transaction takes to close, the more opportunity a VC firm has to back out of the deal. However, the TTO should still do everything it can to help its startup get the best deal possible while at the same time protecting the university's interest in the technology. This should be balanced with the ultimate goal of getting the deal closed in a smooth and efficient manner that benefits all parties involved.

Supporting Entrepreneurship

In addition to establishing relationships with VC investors in your community, there are many things that can be done to support the spirit of entrepreneurship at your university.

Educate Your Entrepreneurs on What to Expect

Educating your university entrepreneurs about what to expect from VC investors will be extremely beneficial in expediting the transaction. Most importantly, startups should realize that VC firms will not write a blank check for their business. VC funders will first conduct due diligence on the company and technology to get a better understanding of whether this company will fit within their fund portfolio. This usually involves a lot of questions, and the founders should be prepared to answer these questions. This also includes a review of any contracts and financial statements of the company. Therefore, it pays to have accountants and lawyers assist you in the preparation of these financials and business contracts to the extent the startup can afford it. If the VC funder finds a contract that did not properly protect the startup's intellectual property or inaccurate financial statements, it will be less likely to invest.

In addition, as discussed previously in this chapter, VC firms are not going to invest in your startup and then sit back patiently and wait to see what happens to their investment. They will want to be involved, and they will be aggressive in making sure they are granted certain controls. This is often times shocking to the entrepreneur who has invested a great deal of time and effort in his or her technology and is unwilling to relinquish any control. Therefore, it is imperative that your entrepreneurs realize the VC firm's expectations up-front and that concessions will need to be made from both sides of the transaction.

Resolving the Internal Struggle Between Academics and Entrepreneurship

One of the primary goals for a research university is to promote research and innovation among its faculty. The purpose behind this is to create and disseminate knowledge for the public good. On the other hand, the goal of business is to provide a financial return to its founders, investors, and employees using this knowledge. This causes an internal struggle between university academia and the entrepreneur. Therefore, if universities are going to embrace the entrepreneurial spirit on their campus, they must recognize how their culture may need adjusting.

One primary conflict among academia and business involves the university's faculty. If universities are going to make the decision to serve as an incubator for venture-based portfolio companies, they must also be prepared for their talented researchers to leave the university to work full-time on their new business venture. Ultimately, universities must create a balance of supporting their faculty and students in commercializing their discoveries through new businesses and serving society's need of developing solutions to society's problems.

Eliminate Red Tape

One of the biggest complaints heard from investors about technology coming out of universities is that it often takes longer to market than other startups, thereby making the investment riskier and less attractive. Therefore, it is critical that TTOs assist productively in the marketing of their entrepreneurs' technology, rather than serving as an additional obstacle to commercialization. Although TTOs should be focused on protecting the university technology, they should also help to ensure that the investment process is streamlined. Ultimately, the TTO should help package the startup's technology to interested VC firms and serve as an intermediary between the VC funder and the startup. They should be helping their startups find funding, not serving as an obstacle to closing the transaction.

Look for Alternative Funding Sources

There is nothing a VC investor likes more than to know that a startup is receiving additional funding from alternative funding sources, such as university or government grants.

First, this adds some additional credibility to the startup's technology. Additionally, a VC firm may find comfort in knowing that it is not responsible for fulfilling all of the startup's capital needs. Government grants are particularly favored because they serve as a source of capital that does not dilute any existing owners' equity interest in the company. University entrepreneurs should be encouraged to look for these alternative funding sources before or as they are seeking venture funding. In fact, VC funders often consider whether a faculty member has a good track record of receiving grants as part of their investment decision-making process.

One primary source of additional funding can be from the university itself. Many research universities offer grants to faculty for various research projects. This is often a good source of initial funding to help jumpstart technology research. There are numerous grants offered by the federal government as well, including grants from the U.S. Department of Commerce for SBIR (Small Business Innovation Research set-aside program for small business concerns to engage in federal R&D with potential for commercialization) and STTR (Small Business Technology Transfer set-aside program to facilitate cooperative R&D between small-business concerns and U.S. research institutions with potential for commercialization).

Additionally, state and local governments may provide grants for certain technologies that have the potential of stimulating economic development in the community. A startup with an additional source of funding is certainly more attractive to a VC firm than a startup that must rely entirely on VC funding. Universities should therefore help educate their faculty on the grant-writing process and provide assistance where they can.

Support a Culture of Innovation

Once a university has chosen to support the spinoff and commercialization of technology developed by its faculty and students, there should be a systemwide movement to support innovation on the campus. This promotion of a culture of innovation may start with the TTO, but should cross over through all aspects of the university. Certainly any success a TTO has in spinning out technology can be used to support other segments of the university, such as fundraising or faculty recruitment.

One way a university can help support an innovative culture is by providing free resources to its aspiring faculty entrepreneurs. These resources can range from classes on business management skills for the university's doctoral candidates to providing free access to certain facility space. Some universities may serve as incubators for certain startups that show high potential for fast growth. These incubators often provide facility space for their university entrepreneurs to utilize during the early stage of their business development, as well as legal, management, and technical advice from other university researchers and outside partners.

Conclusion

University-developed technology has long been an attractive target for VC investors. However, for various reasons, universities have not always been successful in finding venture backing for their startups. One way to improve this success rate is to first recognize which technologies are suitable for venture funding and which are not. Once a technology has been identified as suitable for a startup, the TTO should help to educate the founders on the process and the investors' expectations. Additionally, there are many things the TTO and university can do to develop relationships with potential investors and encourage a spirit of entrepreneurship on its campus. Venture funding is available for your university entrepreneurs. The TTO simply needs to serve as an intermediary between the startup and the investors to facilitate the investment process.

Acknowledgements: The authors would like to thank Dr. Lawrence W. Greer, senior managing partner, Greer Capital Advisors LLC, for his assistance in the preparation of this chapter.