Company formation and the investment process

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A much more detailed description of investments is provided in the book, *Jakobsen PH. Commercialization of Biotechnology Research. Akademisk forlag 2019, ISBN: 9788750055198*.

Introduction

An option for commercialisation of new research discoveries is to establish a new company that can run the commercialization process. In such a process, the commercial exploitation of the research would be placed in the company. The establishment of the company requires that cash capital is invested into the company by investors, who in return get a share in the company and thereby a partial ownership in the company. The investors may get a "premium" return of investment later in time, if the investor can sell the shares of the company or if the company can undergo an Initial Public Offering (IPO). An IPO is the process of taking a private owned company (owned typically by its founders and venture capital investors) to the public by offering the shares of the company to the public market via a stock exchange.

The potential founder of a company will look for investors who are willing to invest cash capital in the company. The process of getting investors may, however, often require a long evaluation and negotiation process that includes the following activities:

- *Defining the business ideas.*
- *Evaluating product profile, relevant technology, the potential market, including any potentially unmet needs of the customers and existing or expected competition in that market).*
- *Defining the business strategy (implementation).*
- *Preparing the business plan.*
- *Making presentations to potential investors and other key stakeholders.*
- *Due diligence activities by potential investors.*
- *Negotiations of terms for investments into the company.*
- *Term sheet based on such negotiations.*
- *Drafting and negotiation of investment documents.*
- *Signing and implementation.*
- *Planning for the next investment.*

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A successful company often builds on ideas with a commercial exploitation potential combined with good implementation of the ideas.

The Business Plan

The first step in the commercialisation pathway is to draft a business plan. The drafting of the plan forces the founders to consider concrete applications of their ideas and discoveries and the money needed to realize the applications. The business plan is a critical document for potential investors.

The business plan (20-30 pages) will typically have the following content:

- *Summary*
- *Business idea (customer need, unique/differentiating factors, focus & profit idea)*
- *Management (competencies & incentives system)*
- *Market and Competitors (market description, target customers, competition, competitive positioning, market entry, marketing and sales strategy, pricing strategy)*
- *Business system & organisation (activities, collaborations, implementation schedule)*
- *Research & Development*
- *Intellectual Property Rights*
- *Opportunities and risks*
- *Potential environment and ethical issues, if relevant*
- *Financial analysis and the amount of investment needed (income, cost, cash-flow forecasts and assumptions, capitalization plan, valuation and investor returns)*
- *Exhibits*

The following issues should be considered when making a business plan:

- *What makes our business idea distinct?*
- *What are the commercial challenges to succeed and how do we overcome them?*
- *What are the critical external and financial milestones and how are they linked together?*
- *Which alliances/networks do we need to build?*
- *What is our business model and which part of the value chain would we like to cover?*

Negotiations with investors

Special investors have focused in making investments in biotech companies. Most prominent are the venture capital investors and the corporate venture capital investors.

Venture Capital is characterised by:

- Most Venture Capital investors are not strongly engaged in very early stages
- Substantial amounts invested (increasing by funding stage), in exchange for significant ownership stakes
- Active role in management, consulting, and also in control of the company
- Specialised in specific industries
- Pre-defined investment horizons (also driven by funding cycles)
- Joint investments with other Venture Capitalists: syndication

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- Preferred stocks: priority over liquidation

Corporate Venture Capital is characterised by:

- Large, established companies create corporate venture capital financing unit
- Examples: Lilly Ventures, Intel Capital, Novo Ventures
- Financial and strategic objectives: identifying and exploiting synergies, gain access to technologies & markets
- Corporate Venture Capital with a more passive role when exercising control rights than independent Venture Capital
- Investment amounts on average higher, also different investment horizons and exit options in comparison to independent Venture Capital
- Operational Support (e.g. R&D) and providing access to crucial business partners

Scientists and/or university tech transfer officers may negotiate with potential investors about establishment of a company upon successful completion of a due diligence (Gogoris A.C. 2001). The main terms of an agreement are normally discussed in the format of a legal document called a term sheet.

The basic considerations for an investment term sheet are summarized below.

Understanding term sheets

A term sheet is a summary of the key terms and conditions on which an investor is willing to make an investment in a company. Term sheets are often non-binding, but they provide the investor with an opportunity to clearly set out the terms and conditions needed to make a deal work. The advantage of a detailed term sheet is that it will provide both parties with a clear understanding of the transaction before they may spend valuable time and resources in an evaluation and negotiation process, with the risk of disagreement about key terms later in the process.

The term sheet has three main chapters:

- *The capital structure of the company;*
- *Governance;*
- *The mechanics of the transaction.*

Capital structure

Capital structure is a term used to describe the parts of a company that forms its capital. For most biotechnology startups, this largely comprises shares purchased by venture capitalists and founders.

An important concept for the term sheet is valuation. The term sheet specifies the "pre-money" valuation the investor assigns to the company. The pre-money valuation represents the money value that the investor determines the company is worth before its injection of new capital. This number lets existing investors and the company know how much of a percentage of the company the investor expects to get for its investment, and consequently how much the ownership level of the current investors will be diluted.

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For example, if the pre-money value of the company is USD 20 million and an investor intends to invest USD 5 million, the investor will end up with 20% of the company.

Exit of investors and their return of investment will be achieved if:

- The company undergoes an Initial Public Offering (IPO) (free trade of shares). This is only relevant for mature companies, and the possibility of an IPO depends on many factors, including the general financial environment of the industry.
- All shares or a limited portion of the shares in a company are sold to new investors or to a company.

If the company cannot succeed in running its business it must be liquidated, or it must be declared bankrupt. The company's activities will cease; this also implies an "exit" by the investors, who, in these cases, will not get any return of their investment.

Valuation

The valuation of a company is critical when seeking investments. Listed companies have a stock price but valuation of an unlisted company is a matter that will be subject to negotiations between the seller of the shares and the investor.

There are a number of valuation methodologies being used for the valuation of unlisted companies. These include:

- Evaluation of single projects and conversion to Net Present Value: This method is normally useful for mature companies with products on the market or products in late development.

- A benchmark methodology comparing the company with other companies of the same size, research budget, product/technology area, number of products, development stage and number of marketed products. Sources of benchmark information may include: consultants, brokers (equity research) and stock exchange websites such as NASDAQ's.

Stock valuation refers to the value of a public company, or more precisely of its equity. In contrast to private companies, the market value of public companies is known at every moment. Shares of public companies are traded at ease.
There are situations where we see dramatic changes in the share price: news on successful or failed trials of lead compounds, the withdrawal of drugs, or successful completion of clinical phases.

References

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Sources of benchmarking information:

Useful websites:
www.pharmadeals.net
www.biospace.com
www.prnewswire.com
www.reuters.com
SEC filings: www.sec.gov
www.edgar-online.com