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How a Venture Capitalist Views Your Business Model

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Venture capitalists review thousands of business plans but typically invest in only a very small percentage of them–1% or so. To winnow the applications down to a few investments, VCs go through progressive rounds of selective criteria. Initial criteria are straight forward. If you prefer early stage investing, you reject deals calling for mezzanine financing. Or, if you only invest in thera–peutics or drug development, you wouldn't look at a medical device company.

Finding the next Amgen

After applying the quick and dirty criteria, the decisions become more difficult in the search for the next Amgen or Genentech. This is not a trivial process. Although Cisco is not a bio–medical company, their humble origins illustrate how difficult it is to spot a winner. Sequoia was the 77th VC approached by the founders–and the company already had revenues. How is it possible that 76 venture capital firms failed to see the potential of a company with a present market capitalization of $160 billion?

Getting on the Short List

So how does a biotech entrepreneur get on a VC's short list? How do they view your business model? Unfortunately, "business model" is an overused and simplistic term. Most biotech businesses are complex, multidimensional structures that don't really lend themselves to a summary sentence. But the phrase has entered the popular lexicon, so one of the first questions asked by VCs is, "What's your business model?"

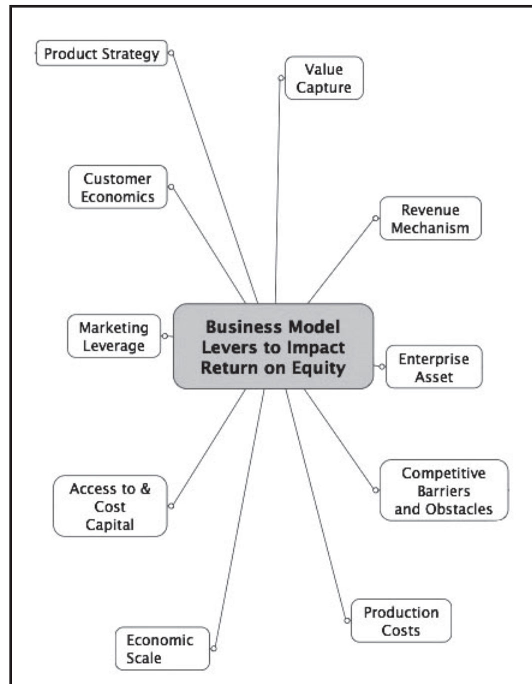

Figure 1: Fully Integrated Business Model
Analysis: FairView Advisers Data Source: Harvard University

Figure 1 illustrates all the ele–ments of a complete business model for a fully integrated company. Needless to say, most biotech start–ups bite off only a small piece of the complete model.

Levers to Impact ROI

VCs are focused at the center of this diagram in terms of the interrelated parts (levers) that impact return on investment, or the VC's internal rate of return. Not all the levers are equally important, but each is a decision that management has made that will impact the IRR, even if the decision is to ignore that particular lever. VCs are intent on maximiz–ing IRR, not growth, not revenue, and not necessarily even market share, though these may all be part of what generates the target IRR.

Other Keys to Attracting VC Financing

Your business plan must address your exit strategy. Since biotechs don't traditionally make profits and pay dividends,

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that's one exit strategy you can rule out. That leaves some combination of being purchased, strategic partnerships, or going public. Another key to a successful business plan is having a "milestone focus." At each milestone (animal data, pre-clinical, IND, clinical and final FDA approval), biotechs create substantial value. But the timing of these inflection points is impossible to predict. Therefore, a biotech must take money whenever it can get it, not just when it needs it. Many biotech executives are overly focused on dilution, so they resist giving away equity. One of the biggest risks a biotech faces is underfunding. If you have a successful product, the returns are large enough that dilution should be relatively unimportant.

Typical Checklist for a VC

Although each VC firm approaches the investment decision differently, some elements are common to all, including the following:

1. Can the product be commercialized? Is there valuable, unique IP, is it truly marketable, what is the opportunity vs. the risk, has there been any proof of principle?

2. Is there a practical, milestone-oriented operating plan that is tied to a future funding strategy including future rounds of financing, and a clear exit strategy?

3. What is the experience of the management team and is that experience validated by previous, successful company experience? Are there well known and published figures on your advisory board? Ironically the most important experience may be that of weathering hard times, and learning from failures. Some of the best managers are those that have been beaten several times. They have seen great technologies lose, are humble, and have learned to manage the risk.

Main Factors Involved in the Investment Decision Making Process

The parameters below comprise the most important considerations in evaluating a business plan. Certainly there are others, and, each VC firm may have criteria distinctive to their style of investing. But, by focusing on the ones below, and making sure the business plan strongly articulates them, a biotech firm considerably improves their chances of getting VC financing. They include: 1) Concept or Science, which should be disruptive or novel, and it should be complex rather than easy to copy; 2) Management, which is the most important element because outstanding management can overcome mediocre science—but not vice-versa; and 3) Market competition and intellectual property, which are important though less important than the first two factors.

Parameter	Company Ranking	Importance	Ranking
Concept	3	20%	0.6
Science	4	20%	0.8
Management	5	45%	2.3
Market	2	5%	0.1
Competition	1	5%	0.1
Intellectual Property	5	5%	0.3
		100%	4.1

Table1: A Likely Candidate for Financing
Analysis: FairView Advisers

Parameter	Company Ranking	Importance	Ranking
Concept	2	20%	0.4
Science	5	20%	1.0
Management	2	45%	0.9
Market	2	5%	0.1
Competition	2	5%	0.1
Intellectual Property	5	5%	0.3
		100%	2.8

Table 2. A Below-average Prospect
Analysis: FairView Advisers

A Tool to Help Construct a Winning Business Plan

VCs use many different methods to reach a decision whether to invest, usually some combination of quantitative, qualitative, experiential or gut level. Regardless of the method, they will evaluate the opportunity based on the key parameters listed above. It's helpful for the entrepreneur to rate their company according to these parameters—highlighting both strengths and weaknesses. A simple, analytical tool to use as an aid is the 3-column matrix that follows, with key parameters in Column 1, a ranking (1-5, with 1 being the lowest) of the company's strength for that parameter in Column 2 and a relative weight (1-10, with 1 being the lowest) in Column 3 (add the weights together and then express the weight of each parameter as a percentage of the whole).

In Table 1, the hypothetical company has good, though not perfect, attributes. Management is outstanding, achieving a perfect score of 5. Science is good and the Concept average–not a disruptive technology. In combination with the other weights, the company achieves a good score and may get financed.

Table 2 has below average management and concept, but outstanding science. This might be a case where the founder/scientist is in love with the science–but it doesn't

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matter. The lack of other crucial strengths leads to a poor score and a company that doesn't get financing.

This approach is almost infinitely flexible to accommodate the individual styles of investing for each venture capital firm. Although it may appear overly simplistic, the tool is a great exercise for an entrepreneur to follow in evaluating how his or her business plan will be received and what parameters are crucial in making the cut. Typically, a company would have to score at least a 3-4 (60%-80% of a perfect score) to be considered.

Summary

The complexity resulting from the interaction of many parameters makes venture capital investing a challenging exercise. It's also the reason why there's no systematic approach to secure financing. However, by focusing on the important business model parameters in this article and perhaps using the analytical tool, a biotech company can certainly improve their chances.

An investment banker can help the biotech company navigate through the complexities necessary to secure financing–making sure the business plan not only focuses on the right mix of elements to secure financing, but also matches up with the right venture capital investors. ■

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