

Finance/Funding



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▼ Convincing a venture capitalist to invest in your idea

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Bioentrepreneurs would do well to follow these basic tenets when preparing to ask venture capitalists for funding.

With the bear market for venture capital a seemingly permanent fixture of the investment landscape, it is critical for the fortunate few biotechnology companies that have secured a meeting with a venture capital firm to present their businesses' value propositions properly and powerfully to potential investors. Venture capitalists (VCs) are in no mood to waste their time—and money—with entrepreneurs who can't communicate their value propositions convincingly. Simply put, the value proposition is: *the reason why a venture capitalist should put money in your company*. This article focuses on the crucial aspects of presenting that value proposition effectively in order to secure funding. To do so, hopeful bioentrepreneurs need to apply a two-step plan to evaluate their business plans: make sure the plan is realistic, and then challenge your assumptions to ensure that your idea is worth the VC's money.

First things first

Regardless of how well an entrepreneur presents a value proposition to a VC, the underlying premise of the business must rest on solid footing. For those pondering becoming entrepreneurs, ticking off the items in our Reality Checklist ([Box 1](#)) is in order.

The idea.

To begin with, a business concept that is easily understood is vastly more preferable than some convoluted notion that requires a PhD in molecular engineering to grasp. The best way to lose your investing audience's attention is to ramble on aimlessly about some esoteric topic that is the basis of a disjointed and opaque business plan. There is power in simple ideas that, if well founded and cogent, will resonate with the listener. Leave the details in the white papers.

The offering.

After the idea is solidly substantiated, the offering itself needs to be clarified. Amazingly, when listening to or reading the business plans of many would-be entrepreneurs, one cannot determine exactly what the product or service being offered is. There should be absolutely no confusion in the mind of the VC—or the entrepreneur—about precisely what the company is offering to potential customers. If such ambiguity exists, then most likely the entrepreneur's potential paying customer won't know exactly what is being sold, and no investment will be made.

The need.

A related issue is the need for the offering. Too often, entrepreneurs are so enamored with their ideas that they don't determine customers' true

need for their products or services. The graveyard of failed startups is filled with solutions looking for problems. If the need isn't clear, then investment won't follow. Entrepreneurs, regardless of how enamored they are of their concepts, must make rational, unbiased assessments of the marketplace's demand for their offerings.

The value proposition.

The next item on our reality checklist is the value proposition. After the idea, the offering and the need have been firmly established, the value of the entrepreneur's specific product or service must be made evident to all potential purchasers. The VC will want some level of certainty that there will be market demand for the offering. Unless there's a perceived value, an interesting concept is likely to remain in the research lab.

The capabilities.

The last point to consider is the capabilities necessary to bring the idea to fruition. Capabilities include money, people, technology and time. If the entrepreneur's idea will take \$1 billion to bring to market, it's almost certain that virtually no one will be willing to commit to such an investment in a startup company. Moreover, if there are only five people on the planet who have the technical proficiency to develop the offering, this effectively puts a ceiling on a company's growth potential. Beyond human resources, the question must be asked: will technology available today, or in the relatively near future, accommodate bringing this idea to realization? *Star Trek* types of technologies make for interesting conversation, but generally do not merit serious investment consideration. Also important is the time factor. If it will take ten years before a product is ready for market, a VC will decline the investment opportunity sight unseen.

Challenge your assumptions

Once the Reality Checklist has been completed, the next requirement before making a presentation to VCs is for the entrepreneur to challenge his or her assumptions. This is often the most difficult of all tasks to accomplish, because most entrepreneurs are optimistic by nature and possess rosy projections of customer acquisition and sales projections that never stop growing. Although both entrepreneurs and their investors desire such a sales trajectory, this pattern is unrealistic, and bioentrepreneurs need to return to earth when estimating revenue growth.

After defining the product or service offering, the questions an entrepreneur has to ask him- or herself are:

- Is this a competitive offering?
- Is this a complementary offering?
- Is this something totally new?

The answers to these questions will dramatically affect the viability of the offering and, thus, a VC's interest. Entrepreneurs must evaluate whether there is a market for their offerings. If there is no existing market, then the onus is on the entrepreneur to demonstrate that future customers will be receptive to the offering. And if a market currently exists, is it growing? VCs want to put money into companies focused on sectors with large growth opportunities, so that their particular portfolio company will be a major player in that space; in order to do so, VCs will perform due diligence on your company. These are areas that a budding bioentrepreneur should be mindful of ([Box 2](#)).

A critical item that many entrepreneurs neglect to consider is who their customers are. If an entrepreneur can't articulate exactly who will write a check for the product or service being offered, this lack of proper market research will be evident to the VC. Even if the customer is identified, entrepreneurs must explain why the customer will purchase their offering. As with any product or service, there are barriers to purchase, such as recessions, customers already locked into a competitor's offering, and relationship-based barriers. All too often, entrepreneurs naturally assume that once customers are aware of the offering, they will be ready to buy. This is probably the biggest hurdle that the majority of entrepreneurs *don't* recognize.

The question that must be answered is: *why should a customer buy your product or service?* Entrepreneurs must also be mindful of whether potential customers can even afford the offering. This is not only a matter of money but also encompasses such factors as complexity of setup, hardware and software requirements, and compatibility issues. It is also important to note that reliance upon distribution partners to get an offering to market is a risky proposition. Most startups don't have enough leverage over such channel partners to ensure that their products or services will land in the hands of targeted customers. A go-to-market strategy that is predicated on others' cooperation will be looked upon with skepticism by VCs.

Entrepreneurs must view their value proposition as a mantra. The value proposition should be a phrase—almost like a slogan—that captures why customers should buy from the entrepreneur. The value proposition needs to be a pervasive element in the entrepreneur's entire dialogue with VCs—a constant drumbeat convincing the listener of the merits of the investment. If the VC is convinced that (i) the offering has merit, (ii) there will be a large, growing market for the offering and (iii) the entrepreneur and the team he or she has assembled have the ability to execute their plans, then investment is more likely. All three of these factors must be embodied in the value proposition. Entrepreneurs must be prepared for

objections about why competitors can't do the same thing for the same price, or even more cheaply. Moreover, if entrepreneurs fail to challenge their own assumptions, VCs may do it for them by asking, "What is the real need for this offering anyway?"

The next assumption to challenge is the valuation of the company. Almost all entrepreneurs overvalue their companies, just as most homeowners overvalue their homes and most job-seekers overvalue their market salaries. Whether a buyer will pay the desired price will depend upon the market. In the current environment, entrepreneurs have to be prepared for drastic reductions in the pre-money valuations of their companies. Because most startup biotechnology ventures seeking funding are not generating profits and their future earnings are therefore purely guesses, standard financial valuation methods such as discounted cash flow analysis are not applicable. Points that factor into how a VC will value the company include:

- The entrepreneur and his or her experience in the field and past success in starting companies
- The management team assembled to bring the offering to market
- Sector focus and growth potential of the market
- To a lesser degree, any existing revenues
- Perhaps most importantly, the market mood

Entrepreneurs must understand that if they go into a bear market looking for money, then valuations are down. During a historic bear market, valuations will be reduced to historic lows. Hence, the entrepreneur should approach VCs with a reality-based pre-money valuation, recognizing that it is a negotiable number virtually certain to be adjusted downward. This, of course, means entrepreneurs are likely to need to give up more of their companies than they anticipate to get the necessary funding. Being myopic in such a situation will not enhance the company's prospects for growth. It is better to own 10% of a rapidly growing, multimillion-dollar enterprise than 90% of a foundering startup.

Deal breakers

Just as there are standard rules for preparing to meet with a VC, there are also some sure-fire ways to ensure that you don't receive any funding ([Box 3](#)). These faults should be avoided at all costs.

Bioentrepreneurs who place ridiculously high valuations on their companies with absolutely no basis in reality—and hold firm to those numbers—simply won't receive funding. If a company has no revenues, no products, barely a proof of concept, and a focus in a sector where well-entrenched competitors reside, and half the earmarked management team are still working at their original 'day jobs,' a \$10 million pre-money valuation is utterly ludicrous.

Such valuations also call into question the market analysis performed by the entrepreneur before starting the company. An entrepreneur developing a new coated-stent product explaining to a VC how he'll beat Johnson & Johnson in the same market space will not be asked to return for a repeat office visit.

Moreover, entrepreneurs who have raised significant amounts of money in the past and basically have nothing to show for it except the employees' pay stubs will be treated with great skepticism with regard to their ability to use investors' money wisely.

Another deal breaker for venture capitalists is companies with no 'real' customers. Although this was more problematic during the days of the internet bubble, entrepreneurs who have business models that don't include real customers paying with real dollars on the other end of the revenue stream will be shown the door.

Finally, the most effective way for an entrepreneur to ruin the chance of being funded is to show up unprepared to present to VCs. Sloppy, disorganized or poorly thought-out presentations are guaranteed to make even the best idea totally unappealing.

Keep things in perspective

An entrepreneur asking someone for \$5 million is on a sales call with a potential buyer. This buyer—the VC—is buying the securities the entrepreneur is selling. As with any purchase, the buyer must recognize and accept the value proposition being presented in order to write a check.

Box 1: Reality checklist

- The Idea: Simple is good
- The Offering: What product or service are you trying to sell?
- The Need: Clarify the market for your offering
- The Value Proposition: Assess your value
- The Capabilities: Money, people, technology and time

Box 2: Preparing for due diligence

Due diligence can be defined as a procedure of care and attention in making all appropriate enquiries into the scientific, commercial, managerial, legal and financial aspects of a company as part of the consideration of a possible investment. For a company, preparation in these areas will pay dividends as the evaluation of the business is undertaken—a clear and coherent business plan is vital. Due diligence is meant to analyze and critique the elements that make up a successful funding proposition. For health care investments, the following are areas where due diligence questions will be aimed and where strong capabilities must be shown.

Business plan

- Do you have access to a range of therapies or technologies with the promise of a stream of products?
- Do you have a proprietary position in the technologies or products?
- Do the applications address major, accessible markets?
- Is there potential to develop corporate alliances with market leaders?
- Are the products commercially viable?
- Are you a team of experienced management with a proven track record in developing products, gaining regulatory approval, and negotiating terms and commercial rights?
- Is the strategy clear and credible?
- Do you have evidence of tight cost control?
- Is the valuation realistic, with milestones to support current and future valuation?
- What is the prospect for divestment within three to five years from initial investment?

Technology

You should be prepared to discuss the details of your technology and its benefits and deficits to what might be an expert audience. Venture capitalists (VCs) will spend time assessing the scientific and technical aspects of the business, using their own knowledge and the skills of a scientific advisory board and external experts. The VC due diligence team will include leaders in their fields, and the team will visit your company and meet the management. In conducting due diligence, VCs apply knowledge gained through prior personal experience, by making comparisons with other companies they know, by conducting research on the sector and by attending conferences and networking. VCs will expect the technology development pathway to be well defined and risks to have been identified. The technical areas subject to analysis are wide and varied.

IP

At the heart of every technology company is the intellectual property (IP) it owns or can generate. VCs are looking for skillful management of the IP assets and will expect to see a patent attorney review of the IP. VCs will also engage their own attorneys to review the portfolio.

Market

For market potential, show the unmet need and your commercialization plan. Make sure the commercial potential will meet the requirements of your funding provider. Above all, be realistic, accurate and truthful—VCs read the statistics, know your competitors and know the markets. You will have to meet milestones that increase the value of your company well in advance of the next financing date.

People

VCs meet a large number of entrepreneurs, scientists and financiers. Due diligence on management includes evidence of past successes, first impressions, the ongoing relationship during fundraising, personal history and team dynamics. There will be recognition of strengths but also identification of people gaps in the business—expect this and have answers ready for likely questions.

Conclusion

The experience of, and approach to, the due diligence process will vary between VCs. Deal-breaking issues are numerous and varied; however, due diligence is about identifying and understanding the risks, many of which are resolvable and an intrinsic part of the investment process. Due diligence will not answer all queries, but gives VCs a level of comfort at which an investment is possible. It is also an opportunity for the budding bioentrepreneur to have the business opportunity professionally tested. Those who achieve funding often look back and appreciate the process, having gained knowledge they later found useful in preparing for the next round of funding.

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Box 3: Red Flags

- Valuation is too high
- Market analysis is suspect
- Little to show for previously invested money
- No 'real' customers
- Value propositions not clearly articulated
- Presenters poorly prepared for investor presentations

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