Follow-On Capital Sources – Venture Capital

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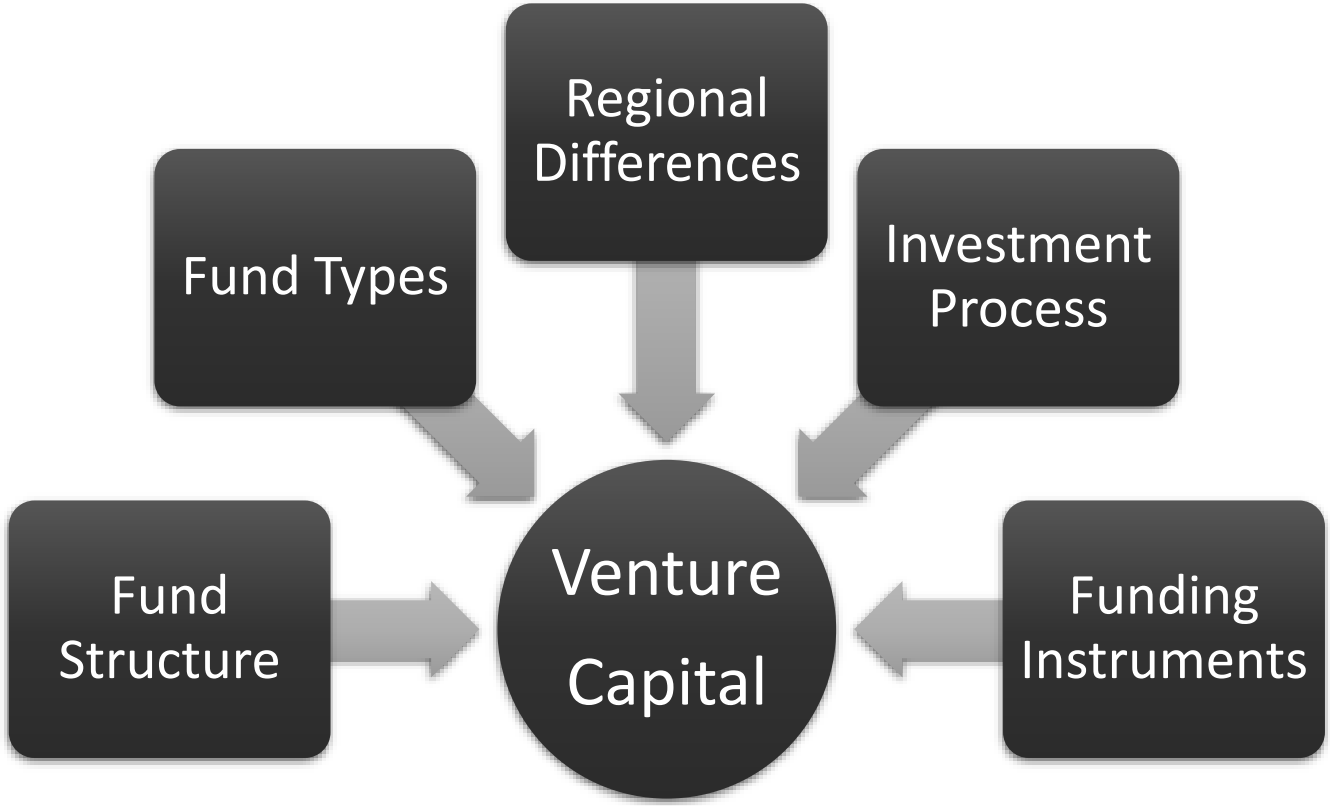
Venture Capital

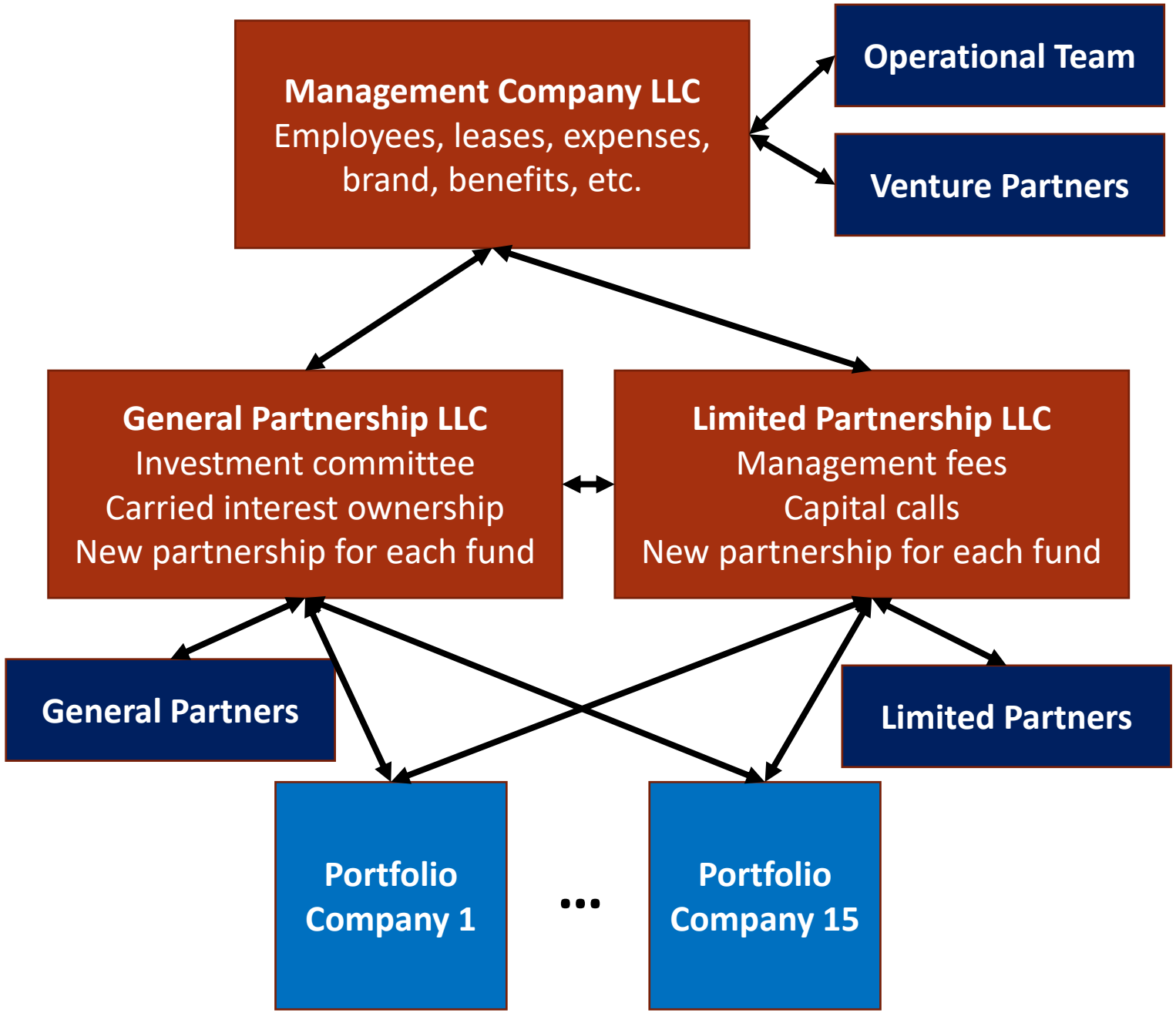


Fund Structure

The Management Company oversees the entire operation providing salaries, benefits, etc. and endures through the entire life of the firm.

General Partners (GPs) work for the General Partnership. They invest, make the investment decisions, earn a small management fee, and receive carried interest on the gains (typically ~20%).

Limited Partners (LPs) are generally institutional investors providing large sums of money for investment. They have little say over investment decisions but make a majority of the gains (typically ~80%).



Fund Types

Type of Fund	Investors	Investment Stage	Check Size	Structural Characteristics
Angel	High net worth individuals or small institutions	Very early, seed or pre-seed rounds	$5k-$100k	Easy to start and flexible strategy, limited resources to diligence or govern
Early Stage VC	Sources with high risk tolerance profile	Seed, Series A or B	$100k-$5M	Structured investments and firm; significant overhead
Growth Stage VC/PE	Large institutional investors; less risk	Series C to E and beyond	$1M-$500M	Highly structured firm with considerable deal and portco support
Corporate VC	Corporation itself	Across all stages, often later stage	Varies	Strategic corporate investments for new tech
Evergreen	Family office or long-term investors	Later stage, less domain expertise	Varies, often smaller	Less structure and higher liquidity, often following
Hedge Fund	Large institutional investors or high net worth individuals	Diverse investments in public and private entities	Often large and diverse	Highly structured; often leveraged; seeking high return, risky investments

Note: this is a vast oversimplification of the diversity of fund types and preferences

Example: ARCH Venture Partners

$1.5B in 2 funds (early stage, growth stage)

- Sources: Large institutional investors, sovereign wealth funds; corporations, endowments
- Where: Worldwide

Early stage life science investments

- Investing in innovative IP at the pre-seed, seed or series A stage; check size $50k - $100M
- Lead investor with a board seat; very involved in building the company

Small confederation of general partners and venture partners with small support team

- Seven general partners make investment decisions and lead investing thesis
- Thirteen venture partners are highly experienced company executives; serve as industry experts and often take leadership roles in company building

Regional Differences in Venture

West Coast

Epicenter of venture capital and risk-taking culture

Domains

Dominated by software, still top in hardware, deeptech and close second in life science

Risk profile

Very aggressive; cutting edge of innovation and ideas

Network

Vast feedback cycle of talent, investors, and entrepreneurs; may only invest locally

East Coast

Rising stars of VC; generally more pragmatic

Domains

Leader in life science (Boston); strong in tech; New York adds software to traditional industries

Risk profile

More pragmatic, heavy technical diligence

Network

Strong LS network in Boston; New York gaining momentum

Midwest

Up and coming; highest ROI region for investors

Domains

Focus on B2B software, deals can be cheaper in the Midwest

Risk profile

More risk-averse than the bay; sometimes more creative than East Coast

Network

Developing feedback cycles in smaller pockets; willing to travel for deals

How to Approach Venture

Be strategic in your outreach

- ARCH sees 8,000-10,000 new technologies for ~25 investments each year
- Find a referral or warm introduction if possible, be succinct and direct with your messaging

Know your product and business

- Have proof that your product works as intended and speak clearly to your differentiation
- Be prepared for difficult questions without hand waving

Know your target market

- Find evidence that there is a market for your idea
- Bring deep knowledge of competitors and innovators in your space

Typical Funding Process

Initial Interest

- Introductory phone call with Team and VC
- Several weeks of Q&A and initial diligence

Deeper Diligence

- Validate differentiation and market
- Team diligence and execution
- IP diligence

Final Investment

- Investment decision
- Term sheet negotiation
- Build syndicate

Funding Instruments

Equity

Preferred Stock

- Paid with liquidation preference (investment multiple) or as common stock; whichever is greatest
- Liquidation preference is paid before common stock, after debt

Participating Preferred Stock

- Receives liquidation preference AND common stock returns
- Total returns cap will convert this to common

Debt

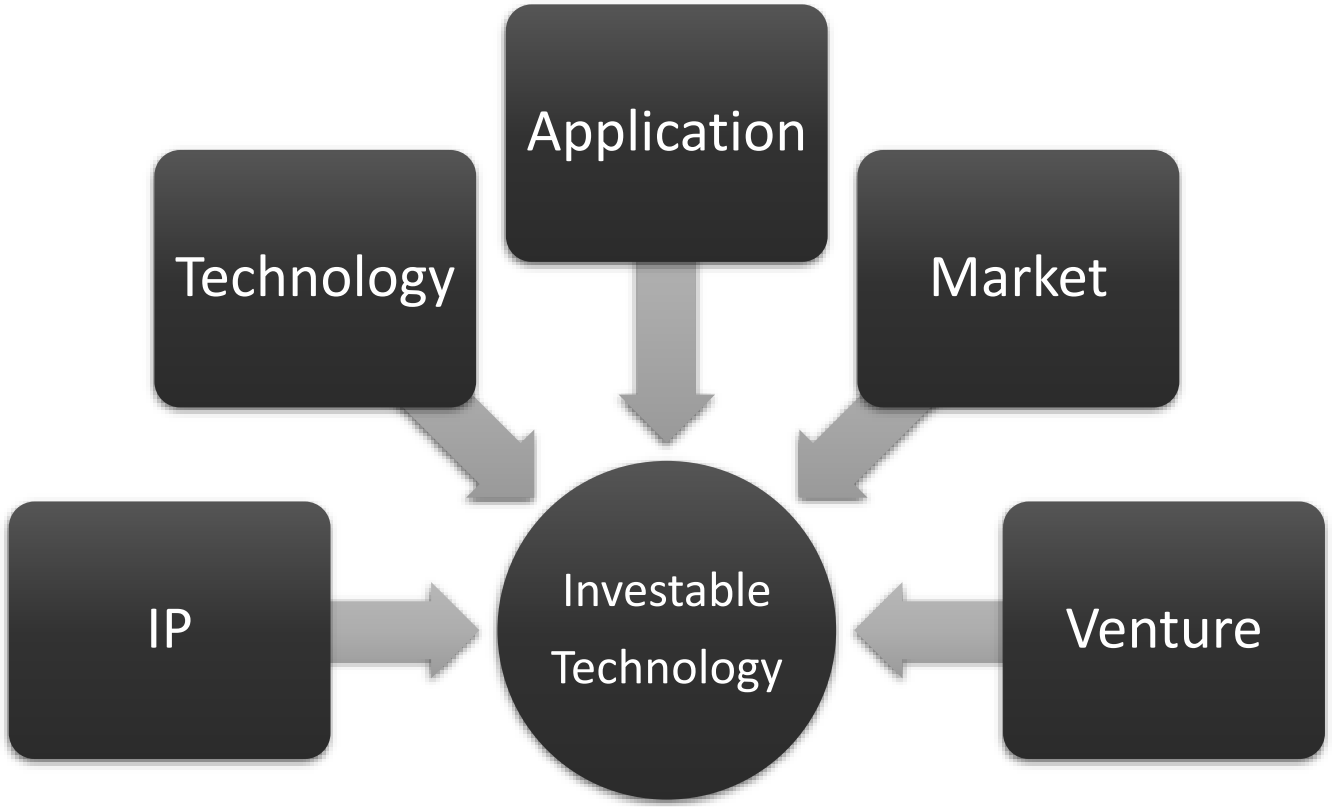
Demand Note

- Preset interest and returns
- Senior claim (first to get paid back)
- Used for special situations

Convertible Note

- Debt that can convert to stock
- Typically converts at the next round of funding
  - Discount
  - Cap

What Early Stage Capital Wants



Intellectual Property

	①	②	③	④	⑤
License	Nonexclusive	Exclusive in a single field of use	Exclusive in limited fields of use	Exclusive	Company owned
Type	No IP	Trade Secrets	Nonobvious Trade Secrets	Methods or Process Patents	Composition of Matter Patents
Stage	Plans to file patent	Patent drafted	Filed	Issued	Recently Issued
Claims	Narrow, Few				Broad, Many
Prior Art	Complex and dense prior art				Limited prior art
Enforceability	Unenforceable, violations cannot be detected				Violations easily detected
Defensibility	Weak				Strong
Network Effects	None				Significant

Technology

	①	②	③	④	⑤
Novelty	Incremental				Breakthrough
Stage	Conceptual	Proof of Concept	Laboratory Scale	Demonstration Scale	Fully Scaled
Remaining Research	Initial or multiple subsequent breakthroughs required	Subsequent breakthroughs required	Parallel breakthroughs required	Engineering remains only	No technical development required
Timeline	>10 years		2-3 years		<1 year
Lab	Unknown PI, small lab, uninvolved		Up and coming PI, medium lab, moderate involvement		Eminent PI and Institution, large lab, highly involved
Demonstration / Proof	None				Peer reviewed / third-party validated
Capital Required	Capital intensive				Low capital
Margin	High COGS, low margins				Low COGS, high margins
Scalability	High cost/time, custom development				Low cost/time, no extra development

Application

	①	②	③	④	⑤
Number	Single	←	←	←	Platform
Validation	Applications unknown	Single unvalidated application	Single validated application OR multiple unvalidated applications	One validated application AND multiple unvalidated applications	Multiple validated applications
Value	Easily substituted		Enables advanced products		Enables new industries
Need	Easily substituted		Solves major bottleneck		Solves issue holding back an industry
Impact	Incremental tradeoff	Incremental improvement	10x-100x improvement in 1 key figure of merit	10x-100x improvement in 2 key figures of merit	10x-100x improvement in >2 key figures of merit
Competition	Crowded with strong competitors		Limited extant competition, strong potential entrants		Unchallenged
Regulatory	Disproportionate threat to this technology	←	←	←	Technology is advantaged
Data Value	Low	←	←	←	High
Partners	None but requires partnerships	Dependent on one partner	Independent with moderate partners	Independent with high-value partner	Many high-value partners

Market

	①	②	③	④	⑤
Number	Few				Many
Size (bottom-up)	Small	<$100M/year	>$500M/year	>$1B/year	>$10B/year
Growth	Declining	Inflation (e.g. ~3% CAGR)	Steady/Market (e.g. ~10% CAGR)	Significant (e.g. >20% CAGR)	Rapid (e.g. >100% CAGR)
Adoption	Slow adoption, lengthy validation, long sales cycle				Rapid adoption, immediate validation, immediate sales
Fragmentation	Many small buyers				A few large buyers / few leaders and many followers
Supply Chain	Buyers or Sellers have immense negotiating power				Buyers and Sellers have no negotiating power
Volatility	High				Low
Customer Acquisition Costs	High				Low
Switching Costs	High from status quo, low from this technology				Low from status quo, high from this technology

Venture

	①	②	③	④	⑤
Management Team	Inexperienced team Many gaps	Inexperienced team	Experienced team Some gaps	Experienced team Filling gaps	Experienced team No gaps Historical success
Excitement	Low excitement	Recovering from overhype	Likely at peak interest	Accelerating interest	Technology trigger
Terms	High-risk terms		Acceptable terms		Low-risk terms
Premoney Valuation	High premoney valuation		Acceptable premoney valuation		Low premoney valuation
Syndicate	Other investors unlikely	Inexperienced investors	Experienced investors	Experienced investors with industry familiarity	Experienced investors with industry expertise
Exit and Return Potential	No comparable exits, no obvious acquirers	Some IPOs or acquisitions, low values	Some IPOs and acquisitions, moderate values	Many high-value IPOs and acquisitions	Uptick in high-value IPOs and acquisitions just starting
Milestones	Unclear path forward				Clear path forward, initial milestones attainable with single reasonable funding round

Other Considerations

- Why has this not been attempted before?
  - If it has, why will it succeed now?

- What would it look like if this deal works?
  - What will make it work?

- What do you think will make this deal fail in the next 2-5 years?
  - What low-scoring characteristics could sink this company on their own?
    - Can this risk be mitigated? How?