

## Thinking like an investor

*The chances of securing investment by sending out an unsolicited business plan to every VC firm you can trace are in the same order of magnitude as those of winning the Lottery - in other words, remote. In the case of financing your young company however, it is possible to shorten these odds substantially, by understanding how investors think, and how they find the companies in which they want to invest. We have spoken to a range of investment managers to ask their views.*

A typical early stage VC sees many hundreds of business plans each year, and invests in only a handful of companies. Most do indeed try to work their way through the pile of unsolicited documentation, but it is understandable that in the first instance they are looking for ways to eliminate as many as possible. After the weird and plain wacky propositions have been removed, many that remain will have dented their own prospects, by sending in bulky and unreadable tomes, or by sloppy writing full of grammatical and spelling errors, or by giving incomplete or vague information. With so many plans to choose from, why should an investor look at any that do not demonstrate pride in the business, and a clear grasp of the proposition being put forward?

Each VC has its own criteria for filtering potential investees. These typically include the amount of funding required, with most VCs not prepared to invest below the £2 - £5 million range. They will take into consideration the stage the company has reached, and most will not invest in a business which is pre-revenue; instead, they will expect sales to be convincing evidence of market acceptance. Most VCs limit themselves to a set of preferred markets or sectors; SEP for example declares its interests to be in information technology, healthcare (note - not life sciences in general), and energy technology. The specialist life sciences VCs can have very specific areas of interest - more on that below.

It is not particularly difficult to research VCs and find out what their 'investment filters' are. It is usually helpful to discover not only the criteria given on the VC's website or in other sources, but also to look at the pattern of its

actual investments. This approach has a much better chance of success, not only because it might locate an interested VC, but also because it leads an entrepreneur to understand what makes the VCs tick. Even if the first dozen VCs approached do not take the bait, the work is not wasted; they will be impressed with the effort to find the right investor, and are that much more likely to give further contacts to other VCs which might be interested in investing.

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Which brings us to the nub of how VCs find companies to invest in. VCs like to follow success, so their principal source of new deal flow is people with whom they associate success. This includes entrepreneurs they have backed before who might be starting a new venture, or colleagues from previous firms where they worked together. It certainly includes co-investors in other deals, and one of the key parts of researching VC prospects is to look at which other VCs they have syndicated with, and whether they prefer to invest alone (often the case for a new company to the portfolio) or to co-invest with others (often the case when larger, later stage deals are negotiated).

Most VCs have a group of non-executive directors whom they like to appoint to portfolio companies, and the word of these individuals is clearly influential. The company's professional advisers - legal, and financial - can also be important, as a firm with prior experience of working with the VC is likely to be more trusted when putting forward an investment proposal than a firm which, even if large and operating nationwide, has no particular network of contacts. ▶



▶ VCs are sometimes blamed for following trends, and it is observable that certain sectors such as cleantech come in and out of fashion. From this account of how VCs rely on recommendations from trusted third parties, this becomes understandable; if a VC sees a competitor or co-investor make a promising investment in one particular area, the temptation will be to follow suit and find another business in the same area. This suggests that there is a consensus agreement on how markets will perform, which changes over time but influences decisions in the short run. Young companies cannot simply change their whole business model to fit the latest VC investment trend, but they should be open to ways in which their business might adapt - for example extending the product range to encompass a cleantech application - to attract the attention of an investor. VCs did not get where they are by misreading markets, and they will usually be keen to share their own views with the entrepreneur's take on where the opportunities exist.

Many early stage ventures in Scotland turn initially to business angels for funding, but it has to be said that VCs are unlikely to invest in a business that has started in this way. VCs do not believe that investment by angels will make a company more investable than one that has been proposed by any of their other sources, and there are various technical difficulties involved in putting an angel/VC deal together; for example, angels must invest in ordinary shares to qualify for EIS tax relief, whereas VCs typically invest in preference shares. David Livesley, Investment Manager at the YFM Group, says that such deals can be done at an early stage if there is give and take by all parties, but the larger and later stage the deal, the more intractable the difficulties become.

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He also comments that life sciences companies should focus on the 10% of VCs which specialise in the sector, rather than "waste their time" on the remainder. Life sciences is a specialist and highly technical area, and it is particularly important in this sector that the investment manager should understand the technology of a portfolio company, and also understand the needs of the market from a technical point of view. There are many specialist VCs with very specific interests in particular technologies, particular market sectors, and particular technological trends; they are more likely than most other VCs to be proactive in following these

interests by attending conferences, reading trade press, and carrying out their own market research. The clear lesson here is that young life sciences companies should ensure that they are visible in relevant sector events and publications.

So make sure you have well connected professional advisers and non-executive directors, research your investor prospects thoroughly, speak to the VC's current portfolio companies and especially to any entrepreneurs that have successfully cashed out, and do all you can to raise awareness in your market niche. There is still no guarantee that you will be able to secure funding, but you will have increased your chances by a large margin!

## Case study: Through the funding maze

***Equity or loans? VCs or angels? Licences or direct sales? Research, or development, or research and development? It can be difficult to know where to start when considering how to develop a new venture which has promising technology, and how to generate funds for doing so.***

***No two companies will be the same, but it is often helpful to track the decisions taken by others under their own specific set of circumstances, and see how these might apply elsewhere. As an example we look at a business based in the North of England, which has grown from a small venture backed by a local early stage investment fund to an AIM-listed business which is still raising funds to support its research and commercialisation activities.***

Plant Impact plc (Pi) was started by Peter Blezard, now Chief Executive, and David Marks, the inventor of the company's key technologies. Blezard had been working for over a decade with a pulp and paper manufacturer, with core responsibilities for European sales and marketing, and Marks had been a director with a multinational fertiliser business.

The idea was to develop a range of non-toxic and ecologically-sound chemistries that could improve the health, yield, and quality of crops. These now include CaT Chemistry (calcium absorption aid), Speedo Chemistry (increases the efficacy of nutrient products), PiNT (nitrogen release), and BugOil Chemistry (a botanical pest control), all at different stages of research and commercialisation. For those interested in the technology, there are full details on the company's website ([www.plantimpact.net](http://www.plantimpact.net)), but for present purposes we will concentrate on how the business was built up.

The first stage was to prove the concept, and the founders were lucky to have EV virtually on their doorstep in Preston. EV ([www.evgroup.uk.com](http://www.evgroup.uk.com)) is a VC firm

which specialises in early stage high growth ventures. Its RisingStars Growth Fund was formed in 2002, with institutional backing from the North West Development Agency alongside the region's key pension funds and banks. RisingStars provided a 'pathfinder' investment of £30K to the new venture, then called BioFutures, a spin out from the founders' base business Pi.

There are no such local VC firms in Scotland willing to invest at the proof of concept stage of a venture, but there are various sources of support including grants such as SMART, and Scottish Enterprise's Proof of Concept programme. These allow the business idea to be proven without requiring the founders to give up any equity. For Pi however, there were a number of advantages in having a VC involved at this early stage; there was a commercial focus right from the outset, while the company was taking several strategic decisions which would influence its future progress and, as we shall see, a VC is able to provide continuity as the business grows to need larger funding rounds from other sources.

Pi knew it had to address international markets from the outset, and had decided upon a hybrid business model, combining sales through its own distribution network as well as R&D programmes which it would exploit commercially via business-to-business relationships. This model holds out the promise of early revenue flows from sales to help fund further R&D, but requires the company to make progress on a number of fronts rather than find a 'quick win' product on which to concentrate resources. The costs involved include field trials, regulatory compliance, IP protection, and the creation of a technically capable sales force and distribution networks - none of which come cheap, and all of which require considerable management input.

After favourable results from the proof of concept phase, Pi was incorporated in May 2005 as a new group company, merging the founders' base business with Biofutures.

At this stage a company in Scotland would in all likelihood turn to one of the several business angel syndicates, which are able to invest relatively large amounts at an earlier stage than most VCs. South of the border there are a few national business angel groups, but local angels and angel networks tend to work as individuals, limiting the amount that can be raised.

For Pi however it was clear that following the success of its initial trials EV would invest further in the business. This it did, alongside management and some other individuals, and its expectations were explicit. The RisingStars Fund is highly focused upon the return to be made from each investment, which in practice means that the company should in principle be capable of achieving an exit within three to five years at a value of over £20M or an uplift to RisingStars of ten times

the money. On the other hand, in EV's own words, "A start-up venture capitalist becomes a company's financial strategist, headhunter, investment banker, and corporate therapist. The RisingStars team has experience of dozens of similar businesses; they can help find the resources the company needs including people, funds, grants, or help in the route to market."

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The company got off to a prompt start, with a number of patents applied for in 2003 and a Middle East office set up and making sales in 6 countries by the following year. Pi started to win prestigious business awards, and by 2005, it was selling in 12 countries and raised a further £600K.

By 2006 the company was making sales in 30 countries, and an IPO (flotation) was planned for that year. Most companies at this stage, when larger amounts of money are required for establishing a firm foothold in international markets, will need to look beyond their initial investors (who in any event will not wish to commit ever-increasing sums), or will look for a trade sale. Although in 2006 a trade sale might have been possible for Pi, it would almost certainly have meant that the founders and original investors would fail to benefit from the company's real potential.

The options for raising larger amounts of capital include finding one or more later stage VCs, or floating on a stock exchange. Both routes put considerable demands on the business; VCs are well-known for driving their investee companies hard, and quoted companies can suffer from macro-level fluctuations in the financial markets, and from micro-level hits when analysts respond to rumours or are sceptical about a company's announcements. Nonetheless, because of the much wider investor base, a flotation gives a company which can demonstrate good progress the possibility of raising substantial sums on a repeating basis.

Pi decided upon an IPO because at that time it was easier to raise money from an IPO than from other VCs. EV helped to arrange a pre-IPO round which introduced two new VC investors, Gartmore and Yorkshire Fund Managers, to give other investors extra confidence in the business. Pi plc was admitted to the AIM market on 16 October, raising £3.85M gross (ie before expenses) at a share price of 38p.

▶ The market was prepared to invest considerably more, up to £6M, but Pi's brokers felt that a small early stage company should not take on too much capital and the amount was scaled back (this has perhaps been subsequently regretted). The shares did well at first, almost doubling in value before the end of the year, but since then Pi like many other companies has seen its share price badly hit, with its fortunes mapping the overall decline in the AIM market.

EV, which at this stage had invested approximately £1M in the business through two funds it manages, did not sell any of its shareholding, seeing the IPO not as an opportunity to make an exit, but rather as a means of raising further funds for the business. Indeed, EV made a further small investment in the business in mid 2009 in its £1.5M share placing (the issue of new shares by a negotiated agreement rather than by trading on the stock exchange), and currently owns approximately a fifth of the company. The 2009 funding was stated to be for the purpose of developing IP protection, carrying out trials to prove the environmental credentials of BugOil, to provide evidence of the efficacy of the nutrient product, and to provide additional sales staff.

It is interesting to note that as the company's R&D continued and more knowledge was acquired of both the products and their markets, Pi changed its priorities for the speed at which different products should be brought to market, with consequences for the amount of funding needed.

During this time the company continued to make progress, signing a five-year distribution agreement with Miller Chemical and Fertilizer Corporation in the USA in May 2008, and in 2009 an exclusive global licensing deal with Arysta Life Sciences for the sale of BugOil. Progress was also made on joint R&D projects, with the company in a consortium which was awarded a €1M research grant from the EU for the development of its 'green' nematicide technology and a soil delivery system.

The company's most recent funding news was a further share placing in February this year, increasing the share capital by some 50% and raising £2.1M gross. However, this placing was at a share price of 15p, less than half the value at IPO, and has incurred some negative

comment from the press. The company is at pains to point out that it achieved a 330% increase in sales revenues during the first six months of FY2010 on the corresponding period in the previous year, and besides the distribution agreements mentioned above has recently signed an agreement with the US Department of Agriculture for trials on PiNT, its nitrogen delivery technology. The BugOil agreement with Arysta was also extended to include a number of Stress Tolerance products, expanding Pi's territorial coverage from 24 to 52 countries, including the southern hemisphere for the first time, the significance of this being that sales in the southern hemisphere give the prospect of year round revenues. This agreement will also result in a significant increase in the number of field trials of the company's products being conducted in the next 12 to 18 months.

*"We continue to believe in the long term success of the business."*

**Julian Viggars**

Head of Technology Investment, EV

In summary, Pi raised some £1.5M before the IPO, and has raised almost £8M since. Its main institutional investors (EV, Gartmore, and BlackRock) have followed their money on each successive opportunity, and in the words of Julian Viggars, EV's head of technology investment, "We continue to believe in the long term success of the business." Technology businesses develop over a relatively long term, which can lead to tensions when set against the short-term outlook of the stock markets. While Pi and its investors will clearly hope that sales will help to fund some of its development, and that the stock market will recognise the company's potential and increase its share price accordingly, it seems that the company made the right funding decisions, and despite the pitfalls is in the best place to prove that it can ultimately give its founders and investors the returns they expect.



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