Creative Ways to Raise Early-Stage Capital
i-Teams Panel Discussion

December 8, 2004 – Graduate students in the i-Teams course heard two CEOs and two investors discuss creative ways to raise early-stage capital for startups. The special session, which was open to the public, capped off i-Teams' inaugural semester and was part of MIT Fall Innovation Week.

Janet Kraus, CEO and co-founder of Circles; Lucinda Linde, investor at Walnut Venture Associates; Mark Lundstrom, CEO of BioScale, Inc.; and Laura Morse, human capital partner of Atlas Venture, discussed fundraising methods including bootstrapping, tapping friends and family, angel investing, and government grants (e.g. SBIR). Deshpande Center Executive Director Krisztina Holly moderated the session, which was hosted by i-Teams Faculty Lead Ken Zolot.

The following is a review of the session that includes the panelists' bios and presentations, followed by a Q&A segment.

BIOS

Janet Kraus
CEO and founder of Circles, a marketing company that creates experiences that develop better relationships between companies and their best customers. American Express is a client. "If you carry an American Express platinum card, one of the features of a platinum card is access to a 24/7 concierge, a live personal assistant who can get you into a trendy restaurant in New York, get you World Series tickets when they're sold out," said Kraus. Since 1997 raised $26 million in venture capital for Circles. Sits on board of the Capital Network. Honors: finalist in 2003 Ernst & Young Entrepreneur of the Year Award, Boston Business Journal 40 Under 40, Circles chosen by Greater Boston Chamber of Commerce as Small Business of Year.

Lucinda Linde
Partner at Walnut Venture Associates, background in both investing and operations. Involved in many startups, including Molten Metal Technologies (an MIT spinout) and Ceramics Process Systems – both ventured-backed startups that went public. Earned materials science degree at MIT, then went to Harvard Business School (HBS). Has been an angel investor of four successful startups and did some early-stage investments at First Light Capital. Co-authored a study on angel investors called VSS Project Report on Angel Investors. "This was a study done under the guidance of Ken Morse, who runs the MIT Entrepreneurship Center, and Howard Stevenson, a professor at HBS. We talked to 55 people, including 25 angels, 12 angel groups, venture capitalists, attorneys, and accountants who work around angels to extract the best practices and how they operate," said Linde.

Mark Lundstrom
MIT alumnus, CEO and co-founder (with three professors) of three-year-old company BioScale, Inc. Involved in four tech startups, has unique perspective on government grant funding. "We make bioscales, very sensitive biomolecular detection systems. The types of projects we're working on right now include bio-defense, human diagnostics, and environmental diagnostics. Funding came from angels, VCs, and government grants," said Lundstrom.

Laura Morse
Laura Barker Morse, human capital partner at Atlas Venture since 1999. Atlas was founded in Amsterdam but has an office in Boston and manages $2.2 billion in early-stage venture capital. Has 87 active companies in the life sciences, software, and communication. Very IP-oriented across the board. Currently investing from a $600 million fund. "Right now my investing partners sit on 70 boards. My focus is to help all the 70 active companies build teams that are going to help the founders realize the vision that brought them together to form a business. I sit in on a lot of the new pitches and have the opportunity to work with a lot of the entrepreneurs on an ongoing basis," said Morse.

PRESENTATIONS
The following is not a transcript. The panelists' remarks are paraphrased.

Kraus
I've been through every stage of financing and can give you one woman's perspective of the stages you go through. I don't sugarcoat anything, to help you avoid making mistakes. There are four stages of financing: getting started (founders' contributions), friends and family (if you need it), angels, and venture capital. We (Circles) did the whole credit card thing for about $50K per founder followed by $400K from friends and family, $1.1 million from angels (which is like herding cats), and then $25.2 million from venture capital. A few highlights in each stage:

Getting started, e.g. bootstrapping (first 18 months): Potentially, individuals have about $50K to put in, plus sweat equity. We went from credit card to credit card to raise individual funds.

Friends & family (F&F): $25K to $500K. Can you honestly look them in the eye and tell them it's equity, not debt (they will not be getting it back)? Be clear that the early stage is risky. You must be positive that they will be OK losing that money.

Angels: When I raised angel money, there were very few angel groups (as opposed to individual investors). Groups make it easier, because there are some identifiable people to whom you can talk. Traditionally, angels have been just rich people who have some psychic interest in helping entrepreneurs grow businesses and who have the intention of getting a return. I herded 25 individuals to the swimming pool. I think the key there, if you're going individual instead of groups, is people who are considered very credible in the marketplace – maybe they're VCs or entrepreneurs. It's important to have very

credible, early-stage investors so that when you go for later rounds, your early-stage investment hasn't hurt you.
Venture capital: Somewhere in the neighborhood of $2 million. The key: do a lot of homework on which VCs you want to talk to. Know about their partners, what they're invested in, and whether they've been successful. Be choosy. They're going to be your partner for the rest of your existence; you want to make sure you have good karma with them. Meet folks before the pitch if you can, and be really clear about the most important parts of your story. A lot of times, VCs' eyes glaze over after page 3 if they think this is a 25-page deck. Develop a very clear, concise presentation. I talked to about 60 VCs before I realized I was talking to all the wrong people, because tech companies don't invest in business services. When I found companies that do invest in business services, lo and behold, it took about seven days.

The things that make people invest are:

- A big market with clear needs. A solution with clear benefits (those that drive revenue or decrease cost)
- A great team (among other things, consider whether you need "window dressing," e.g. a prominent professor)
- A good objective understanding of why your business is great and also a ton of passion about it. But don't let passion overwhelm objectivity.
- Nice to haves: real competitive barriers. A "comparable" – we're going to be just like this company that was really successful. The diff is X – makes your story really tight. It's nice to have competitors. If you don't, it's a question about the market.

Linde
Angels operate in a rich diversity of styles and motivations, but they fall along two axes: relevant industry expertise and relevant entrepreneurial expertise.

- Guardian angels: people who understand the business you're in and who started a business in that area. They're good to have on your board. They can provide contacts, etc. and are highly valued by VCs.
- Executives from large industry players: good to have as advisors. They can provide industry contacts, but they may not have lived the process of establishing an entrepreneurial company.
- Entrepreneurs who don't have industry expertise.
- Angels who don't have industry or entrepreneurial expertise. They might have made money from dentistry, real estate, etc. and can only provide capital.

Angels can play a crucial part in the early stages of business. VCs sometimes have as much as 70 percent of their fund with repeat entrepreneurs, while angels often invest in first-timers. Angels are known for not having much valuation discipline or due diligence. They can be anything from passive to highly active. VCs will be active because of their large stake.

Angels do it not just for the return – they're giving back to the next generation of entrepreneurs, they like to be involved, to maintain their networks, and they like the intellectual challenge.

Lundstrom
I would not advocate free money as the only money one goes after, but for the right technology and right types of applications, free money is sometimes good money. This type of funding can come from government programs, such as SBIR (Small Business Innovation Research) grants. Some departments (e.g. NIH and NSF) will actually fund something because there's a good commercial opportunity and a societal need. The DoE will look at things as a chance to get an engineering job done.

BioScale and ECS were both funded with a hybrid strategy of raising angel, VC, and grant money. In both cases, we were able to effectively use government grants to almost skip series B funding. There is still a need to raise the initial round of equity. With ECS, we created a platform technology that has a large number of potential applications (a few ECS technologies were used in sports equipment, and the company was bought eventually). The government is interested in funding such platforms. Grants can end up being application development money.

Beware: free money is not fast money. How long does it take? Large grants ($ 1 million or more) can take 18 months, minimum. If you're going with a grant strategy, you should also raise private funds. You'll need money sooner if you have a good technology. If you do raise a certain amount of series A funds, that will help your grant chances, as well as allow you to do market research.

Pursue SBIR grants to develop either 1) a technology that meets a well-defined market need or 2) a subsystem of a platform technology. Those are the two criteria we use to choose whether we're going to go after something or not. Types of technologies well suited to SBIRs are platform and things that can help in health care and defense. That's where the money is. (For more on SBIR grants, see [link].

Morse
Raising money for a new venture is a continuum. It also isn't either/or, because all the strategies, as Janet pointed out, can be employed by one company.

A couple of things to consider: The incubation process is a funding source that was popular during the [dot.com] bubble. What's going on at the Deshpande Center is more wired into the real world, it's a real advance of what we were looking at in the late '90s. Another thing with funding early-stage companies is the concept of [traunch?] deals. You shouldn't assume that because the firm has a lot a money, they won't be interested in a small amount, initially. They're interested in whether there's a big idea and whether there will be an opportunity to put a lot of money to work once certain milestones are reached. Regarding milestones: a grant can complement and extend your shelf life and help you avoid going back to your 'expensive money' too often.

Generally, we look at companies that have spent time thinking about what they'll do long-term. The longer a company can wait before going to a classic VC – and at the same time still reach milestones around product development, market development – the higher your pre-money valuation will be. Finding a person, like a Deshpande Center catalyst, who is credible and who's been through the hoops is going to make your experience much better. The research you do on the right people to approach, specific partners who have the right expertise, is critical. It's easier now to do that kind of research, especially with resources like Google.

Also, you can find out what the funding models for firms are. Meet the partners. VCs are very interested in meeting entrepreneurs; it's a two-way activity. Beware that VCs have a nose for whether a deal has been shopped to everybody. If it's exclusive, it's more interesting.

Watch out for hairy deals – too much trouble. One MIT professor was very proud of the way he had structured debt financing, etc. Then, when he wanted to go to VC, there was no way to unwind what he had put together, it was so cleverly done. Keep it straightforward.

I can't emphasize enough: it's going to take a lot longer than you think. Eighteen months is not unusual. Five years is the time frame you'll be spending with your investors. One thing to understand about venture investing is that the goal of most of your pitches will be to get a term sheet. That may only be the beginning of the due diligence. Each firm has a different way of looking at the due diligence process.

Our firm does a lot of DD before the term-sheet stage, but there are lots of firms who view the term sheet as a way to get their foot on a deal so they can take as much time as they choose to do the deep dive on the markets, people, competition, etc. A lot of times, first-time entrepreneurs will get a term sheet, assume the deal is locked up, and not develop enough alternatives, only to find that the initial interested investor will come back with a lower valuation, change the terms, or just walk. It's never over 'til it's over. You shouldn't ever hesitate to ask whether it's OK to talk to CEOs of current portfolio companies or others in the market who know the venture investors.

What will VCs do for you that others won't? They should be able to provide good industry and customer connections. Test them on this. Find out who they know.

Critical: what is the money you're raising going for? If it's going for R&D and you can get a grant, this is terrific, because it'll extend the time to work out of cash. How long is the money going to last, what's the burn rate? This is a big issue for VCs. Another important consideration for VCs is who is making the decisions about your company – who's on the core team. They'll want to weigh in on this.

Q&A

Angel funding and bootstrapping
Lucinda: One prerequisite for getting angel investing can be getting financing from customers, if you've got something you can get into their hands. Getting customer validation – actually selling a product – at the angel-investing stage means that angels can see: 'How are customers going to react to this?' This is crucial before approaching VCs. Walnut looks for this in some cases.

Janet: Because we already received F&F funding, our angel round was about proving that the market was big enough for this idea to be venture-fundable; would the idea be only a $10 million business that would give return to angels and F&F, or would there be big elephants we could go after? Angels can be perfect for those who want to build a product and sell it quickly (e.g. to a company), skipping the VC funding and company-formation stage.

Group vs. individual angels – groups are slightly more like VCs; you have to research them and "shop" them. With individuals, you must spend a lot of time cultivating relationships. Spend the first three months getting to know someone but not signaling you're looking for money. Wait for them to tell you they're interested in what you're saying, so that you don't have to be the one with the hand out. It's like dating.

Mark: You need a reason for your angel round. You need to show why you have an attractive enough fishhook for a yet bigger fish downstream to bite on. Setting a price: I've done seven angel rounds ranging from $200,000 to $5.5 million and ranging in participation from four to 60 people. It's very difficult to set an initial price sometimes. One way – I got a term sheet from a VC and used that as the price-setting event to do an angel round.

Finding angel investors
Lucinda: The best way is to network your way in if you can. These people can be found at entrepreneurial events.

Mark: You need a good network to find angels. Network passionately and aggressively. Ask angels to provide introductions to others. Think of it as not about asking for handouts but as offering an opportunity to make a lot of money and do a lot of good for society.

Top piece of advice
Mark: Always have a backup and never assume anything's done until money's in the bank.

Lucinda: Keep an open mind. Zig and zag. Listen to feedback and iterate.

Laura: If you can imagine being an employee, you should go and do that, because a startup takes 10 years and requires a lot of passion.