"Whistles Don't Pull Trains"

Fostering Innovation, Raising Capital
and Surviving the Valley of Death

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“Whistles Don’t Pull Trains”

“Noise does not move companies. People move companies. Smart people, motivated people. Bold, confidant people. …who don’t just talk - they act.

We’re not talking about action for action’s sake. We’re talking about eyes open, feet firm on the ground, evaluating your situation so that, when the time is right, you make the right things happen.”

- RICHARD PRIORY

President & CEO
Duke Energy, 2001

Agenda

1. Fostering innovation in the Hunter
   - What are the essential ingredients for an innovative ecosystem?
   - How does Newcastle & the Hunter meet the criteria?
2. Raising capital for start-up companies
   - The Golden Rule
   - Sources of finance
   - How is it invested in Australia?
   - VC & PE investors’ behaviours & priorities
   - Strategic investors’ behaviours & priorities
   - Investors’ IRR hurdle rate
   - Valuation
   - Exit strategies
3. Discussion, Q&A

Creating an Innovative Ecosystem

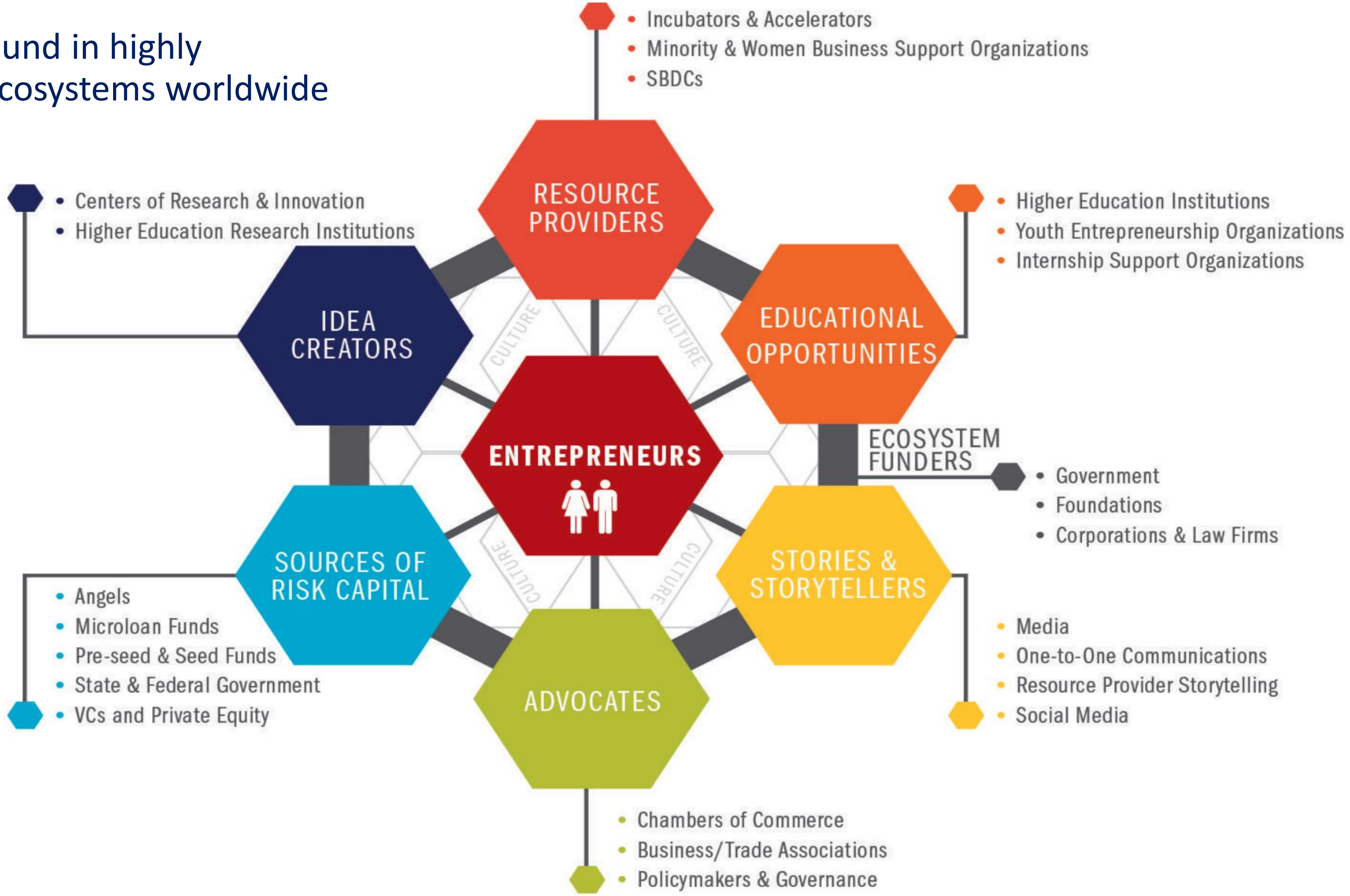
- Finland
- Singapore
- Silicon Valley

An Innovative Ecosystem - Singapore

Source: Zach Tan (sg.linkedin.com/in/sctan)

An Innovative Ecosystem in Newcastle & the Hunter

- Essential ingredients found in highly successful innovative ecosystems worldwide



Silicon Valley – the world's most successful innovation ecosystem

1. The world's greatest assembly of scientific research organisations
   - Five world-class research universities
     - UC Berkeley, Stanford, UC Davis, UC Santa Cruz, UC San Francisco
   - Five US national laboratories
     - Sandia, NASA Ames, Lawrence Berkeley, Lawrence Livermore and the Stanford Linear Accelerator
   - Multiple, world-class research institutions
     - Xerox PARC, SRI, CITRIS, IFTF, JBEI. Buck Center on Aging
     - Corporate research labs: HP, Googe, Intel, Agilent, Genetech, IBM
2. Seven decades of intensive federal R&D, seed funding and technology spin-off
   - US DoD and the Defense Advanced Research Projects Agency (DARPA) have been key drivers of investment and innovation in Silicon Valley

Silicon Valley – the world's most successful innovation ecosystem

3. Access to a large amount of risk capital
   - 40% of all US venture capital is invested in Silicon Valley
   - 7 of the top 10 VC firms are based there
4. Home of many of the world's top tech companies
   - 6 of the world's top 10 companies, combined market cap US$1.8 trillion
5. Inviting location for highly skilled talent
   - Has twice the US national average % of people with Masters and PhD degrees
   - More than 50% of start-ups have at least 1 foreign-born founder

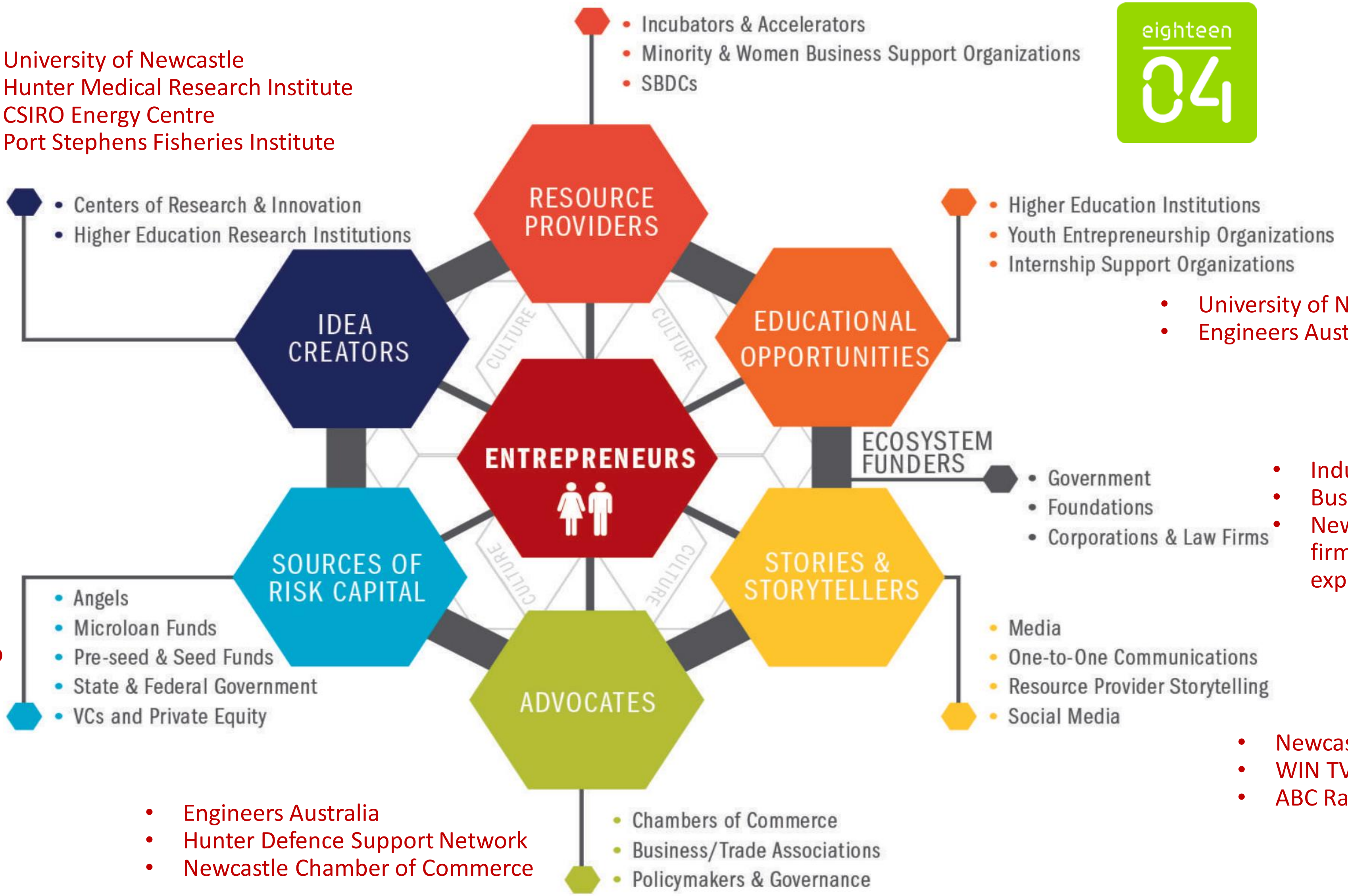
These factors have combined to create a virtuous, self-sustaining innovation ecosystem

Source: How the Silicon Valley innovation ecosystem creates success, Stephen Ezell, Information Technology & Innovation Foundation, November, 2014

Newcastle & the Hunter Region of NSW

- Largest regional economy in NSW
- Strong local industries
  - Coal mining
  - Mining engineering services
  - Advanced manufacturing
  - Defence & aerospace
  - Large shipping terminal / direct access to global markets
  - Wine, food & tourism
  - Largest producer & exporter of premier thoroughbreds
- Excellent tertiary education & research network
- Federal & state government regional offices
- Population of 726,500
- Contributes $32.3 billion to NSW's economy (!!!)

How does Newcastle & the Hunter meet the criteria?



Idea Creators:
- University of Newcastle
- Hunter Medical Research Institute
- CSIRO Energy Centre
- Port Stephens Fisheries Institute

Educational Opportunities:
- University of Newcastle
- Engineers Australia internships

Ecosystem Funders:
- Industry, Innovation & Science
- Business NSW
- Newcastle corporations & law firms with global business experience

Sources of Risk Capital:
- Hunter Angels
- Business NSW
- Australian Industry Group
- R&D Tax Incentive

Stories & Storytellers:
- Newcastle Herald
- WIN TV
- ABC Radio Newcastle

Advocates:
- Engineers Australia
- Hunter Defence Support Network
- Newcastle Chamber of Commerce

The cultural environment is also important

- Fostering a distinct “innovation culture” / mindset is a key success factor:
  - Openness to new ideas
  - Question the status quo
  - Do things that have never been done before
  - Set ridiculously ambitious goals
  - Easy movement of people, ideas and capital
  - Experiment; rapidly iterate
  - Take acceptable risks; don’t fear failure
  - Fail fast to succeed sooner
  - Get to market first because scale matters
  - It’s not how much R&D $$ you invest, but how you invest that capital

Source: The Culture of Innovation: What Makes San Francisco Bay Area Companies Different? , March 2012

Discussion / Q&A

Raising Capital for Start-ups

The Golden Rule…

Those who have the gold make the rules

Sources of Capital

STAGE	$	SOURCES OF CAPITAL
"Bootstrap Capital"	$50k - $500k	3Fs, Angels, Govt business development programs / incubators
Seed / Start Up	$1m - $2m	Angels, Early Stage VCs
Series A / Early Stage	$4m - $6m	Banks / Business Lenders, VCs, Strategic Investors
Growth Capital (Series B & C)	$10m - $15m	Banks, VCs, Strategic Investors
Expansion Capital	$20m +	Private Equity, Strategic Investors, Local or Overseas IPO

Australian Venture Capital and Private Equity Investments – FY2017

Venture Capital

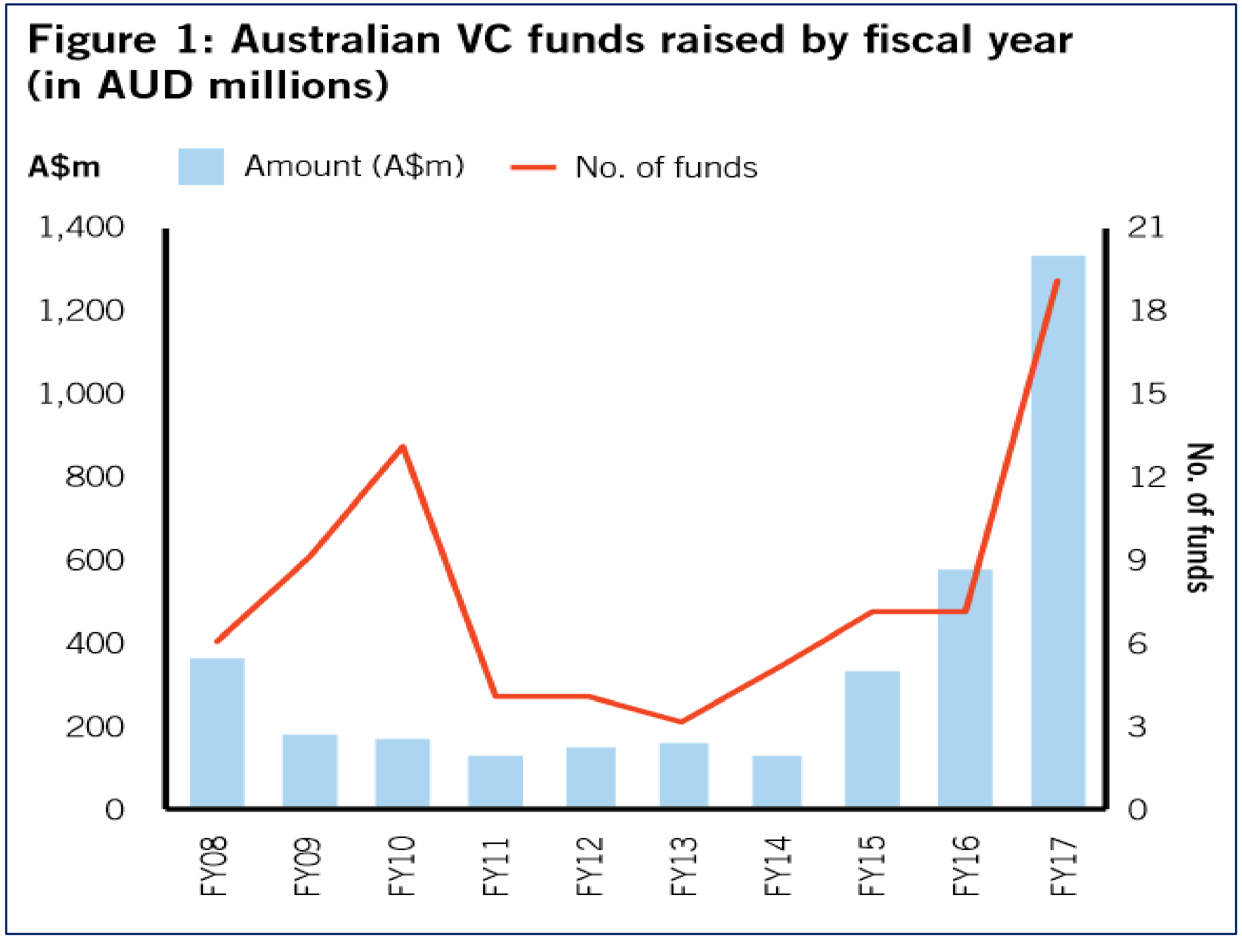
STAGE OF INVESTEE COMPANY	AMOUNT ($m)	INVESTEES	%	Av ($m)
Seed	51.38	46	12%	1.12
Start-up	95.63	22	22%	4.35
Other early stage	135.74	34	32%	3.99
Late stage VC	129.14	11	30%	11.74
Other VC	17.47	4	4%	4.37
Total VC	**429.36**	**117**	**100%**	

Private Equity

STAGE OF INVESTEE COMPANY	AMOUNT ($m)	INVESTEES	%	Av ($m)
Expansion/growth capital	975.33	21	29%	46.44
Rescue/turnaround	68.91	7	2%	9.84
Buyout (MBO/MBI/LBO/P2P)	2,010.46	9	59%	223.38
Other PE	327.32	2	10%	163.66
Total PE	**3,382.02**	**39**	**100%**	

Source: Australian Venture Capital and Private Equity Association Yearbook, FY2017

VC Funds Raised FY2008 – FY2017



Note
Of the 19 new VC funds raised in FY2017, 11 were Early Stage funds

Source: Australian Venture Capital and Private Equity Association Yearbook, FY2017

Types of Investors

Angel Investors

- Experienced, financially successful entrepreneurs
- Typically invest $50K - $500K
- Prepared to syndicate with other angels
- Can be patient investors
- Acquire equity at a low entry price due to very high risk & for their expertise and involvement
- Expect to perform a mentoring role
- Like to get deeply involved in your business

Banks / Financial Institutions

- Second cheapest form of finance
- Provide security-based, debt funding
- Higher the risk, higher the interest rate
- Unlikely to provide any support beyond the money (i.e., “dumb money”)
- If you breach your loan covenants, bank may “call in” the loan
- Do not require equity but may seek to convert dept to equity in exceptional circumstances

Types of Investors - VCs

Venture Capitalists' "Behaviours"

- VCs do not provide exits for founders
- Major red flag is money to existing shareholders
  - only provide capital for growth
- Will be totally growth focused & exit determined.
  Not interested in dividends - net profits re-invested in growth
- Will seek to exit via a trade sale or IPO, usually with 3-4 years
- Will seek high multiples at exit (min IRR 25%)
- Will exert control through "negative pledges" in the shareholders' agreement if things go pear-shaped
- Professional & unemotional - tough negotiators

VCs' Investment Priorities

1. The Exit
   (how will I exit this investment in 3-4 yrs?)
2. Management team strength
   (commercial experience, track record, skills mix, etc)
3. Size & dynamism of your market sector
   (the market /demand must be large & fast growing)
4. Your strategic position relative to competitors
   (great business plan, channel partners, customers, etc.)
5. Financials
   (Financial model must prove required target IRR)
6. Technology / IP
   (uniqueness, patents, barriers to entry, etc.)

Internal Rate of Return (IRR)

Fig 1: IRR Table

Investment ($AU M)	IRR after 3 years ($AU M)			
	25%	30%	35%	40%
1.5	2.93	3.30	3.69	4.12
2.0	3.91	4.39	4.92	5.49
2.5	4.88	5.49	6.15	6.86
3.0	5.86	6.59	7.38	8.23
4.0	7.81	8.79	9.84	10.98
5.0	9.77	10.99	12.30	13.72

Fig 2: The IRR Hurdle Rate at Exit

Initial VC equity investment	= $3M for 30%
Post money valuation	= $10M
Required IRR at exit	= 35% after 3 yrs
VC's 30% equity must be valued at	= $7.38M
Company's exit valuation	= $24.6M

Types of Investors – Strategic Investors

Strategic Investors' "Behaviours"

- Make investment decisions on strategic fit & market potential
- Believe they understand the market better than you do (and they usually do)
- Seek mechanism for eventual 100% ownership
- May allow some money to go to the owners
- Sometimes emotional about the transaction – may pay a strategic premium
- Will always see the investment through their "strategic lens"
- Shareholder relationship may change on change of CEO, etc.

Types of Investors – Strategic Investors

Strategic Investors' Priorities

1. Your strategic fit with their business
   (you fill gaps in their product suite or market coverage)
2. Technology / IP
   (uniqueness, patent protection, R&D plan, etc)
3. Your strategic position relative to competitors
   (especially existing customer base & market channels)
4. Financials / Business model
   ($$, great business model, channel partners, customers, etc)
5. Management strength
   (has staff to fill "skills gaps" in your team)
6. The Exit
   (can be a patient investor, depending on "strategic benefits")

Valuing your company – some ground rules

- It's pointless speaking to any investor unless you have an informed idea of your value
- A major investor is not interested in holding a 5% equity stake in your company
- They want a significant minority stake, e.g., 25% - 40%. Devise your offer accordingly
- Valuation methodologies:
  - Recent comparable transactions in your sector (EBITDA or revenue multiples); or
  - Recent "near comparables", with multiples adjusted (up or down) due to size, relevance, scale, etc.
  - Discounted EV/EBITDA and EV/Revenue multiples of comparable ASX-listed entities
  - Discounted Cashflow (DCF) method[1]

1. DCF is usually not applicable to start-ups because it relies on accurate, multi-year, future cashflow forecasts to calculate Net Present Value

Valuing your company – some ground rules

- Best approach is to use more than one valuation method
- But only promote the one that produces the highest pre-money valuation
- Notwithstanding, investors will always come to their own view of value
- It’s always a tough negotiation.
- Optimise your position by having “evidence” that supports your position on value

The Exit

Exit Options

- Trade sale to a strategic investor or PE buyout fund
- IPO or Reverse IPO
- Merger with another strategic player
- Management buy out (MBO)
- Management buy in (MBI), maybe with PE backing
- Liquidation / orderly winding up

Local or Overseas IPO

- Usually structured as a partial sale of existing shares + an issue of new shares
- Not a 100% exit for founders, but a partial exit
- Usually provides an exit for the VC
- Source of growth / expansion capital
- To get institutional investor's buy in requires the IPO to have "critical mass", e.g. post IPO market cap >$100m
- IPO process can be lengthy, complex and expensive, e.g., run-up period can be 6 months
- ASX compliance costs can be expensive

Discussion / Q&A

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