

The InnovUS Guide



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This booklet provides valuable information on key aspects of innovation varying from patents, business plans, company formation, bridging the gap between research and taking the research to the market, and legal and tax issues, and brings together the experience of leaders in their respective fields.

We believe that this guide will be a very useful resource for any researcher or entrepreneur considering the commercialisation of an idea. The topics were chosen with great care to provide a broad overview and a practical foundation for innovation, but very specific advice will without doubt be needed for each commercial transaction.

InnovUS

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FOREWORD

Leopoldt van Huyssteen

Executive Director
Operations and Finance



1. INNOVUS

The focus on commercial exploitation of intellectual property is relatively new to South Africa. Stellenbosch University, with its credo “Your knowledge partner”, has long been committed to technology transfer in order to benefit our communities through the establishment of competitive industries. InnovUS Technology Transfer (Pty) Ltd is a pioneer in the field of technology transfer in South Africa. Despite being only 10 years old, InnovUS is one of the oldest technology transfer offices in the country. Our inventors and researchers continue to set new standards and stretch the boundaries of what is considered possible in the innovation space. In addition, InnovUS has registered 52 patents, both locally and internationally – this is an incredible performance for an initiative that has only been in existence for a decade.

Every innovation starts with a great idea, but actually developing and patenting your idea can be an incredibly challenging process. With this in mind, InnovUS has gathered the expertise of a range of industry leaders and collated it in this booklet. It is our hope that you will use this information to join the growing ranks of our groundbreaking inventors and researchers.

Furthermore, I would like to extend an invitation to Maties alumni who are leaders in their fields to become involved with InnovUS, either as business advisors, co-investors or board members in our exciting portfolio of spin-out companies. We have many new and challenging initiatives on the table and invite you to join us in supporting these ventures.

March 2010

INNOVUS

Anita Nel

Chief Executive Officer



InnovUS Technology Transfer (Pty) Ltd is Stellenbosch University's wholly-owned technology transfer company, managing the commercialisation of the University's innovation and intellectual property portfolio through patenting, licensing and the formation of spin-out companies. The company was incorporated as a wholly-owned subsidiary of the University in 2009.

It is our passion to ensure that the world-class outputs of our researchers and inventors at Stellenbosch University are brought to the market. We understand these researchers want to focus on their specialist areas and it is not always easy to bring these amazing and truly remarkable breakthroughs to the market.

This booklet provides valuable information on key aspects of innovation varying from patents, business plans, company formation, bridging the gap between research and taking the research to the market, and legal and tax issues, and brings together the experience of leaders in their respective fields.

Thank you to each of the contributors for sharing their insights and business acumen with us and for adding unique and significant value to this book.

We believe that this guide will be a very useful resource for any researcher or entrepreneur considering the commercialisation of an idea. The topics were chosen with great care to provide a broad overview and a practical foundation for innovation, but very specific advice will without doubt be needed for each commercial transaction.

I extend a special invitation to our researchers and staff at Stellenbosch University to disclose your inventions and to create an entrepreneurial culture on campus. By introducing science to the market where it benefits our people, we become a relevant University that brings hope and contributes to the South African – and African – society. Be assured that our skilled staff at InnovUS will assist you to protect your intellectual property and to negotiate agreements so that you can ultimately also reap financial benefit from your inventions.

Whether you want to license your technology or start a new company based on it, we can help you. We wish you a very successful and exciting journey from the lab to the marketplace!

March 2010

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INTELLECTUAL PROPERTY RIGHTS FROM PUBLICLY FINANCED RESEARCH AND DEVELOPMENT ACT, 2008

Towards improved IPR management and value extraction from public funding of research and development in South Africa



McLean Sibanda

In December 2008, the President of the Republic of South Africa signed into law the Intellectual Property Rights from Publicly Financed **Research** and **Development Act** 2008 (**Act** No. 51 of 2008). This act, known as the IPR Act, was championed by the Department of Science and Technology (DST), and signified a very important milestone towards improving management of intellectual property (IP) emanating from publicly financed research and development (R&D). The object of the IPR Act is 'to make provision that intellectual property emanating from publicly financed research and development is identified, protected, utilised and commercialised for the benefit of the people of the Republic, whether it be for a social, economic, military or any other benefit'. The IPR Act finds its basis from the 2002 National R&D Strategy which identified a need for a policy and legislative framework for managing IP emanating from publicly financed R&D.

The IPR Act is one of a number of interventions by government to enhance innovation in South Africa and address some of the concerns in publicly financed R&D. From an IP management perspective, these concerns included the lack of a harmonised approach to managing intellectual property emanating from publicly financed R&D. This has often resulted in IP leakage from publicly financed institutions with the public getting very little benefit. Further, most higher education institutions have not had policies regulating declaration of IP from publicly financed R&D,

ownership of such IP, commercialisation of such IP and disposal of such IP. The lack of benefit sharing policies to reward the creators of such IP also meant that there were no incentives for the IP creators to disclose such IP. The lack of harmonised approach has also been a source of uncertainty on IP matters by third parties when transacting with publicly financed institutions. Furthermore, as set out in the 2007 Innovation Fund Special Report on the State of Patenting in South Africa, over a 15 year period, South African institutions accounted for around 4% of all patent applications originating from South Africa. This is a very low patenting rate considering this comprises the most concentration of knowledge workers in the country. The lack of appreciation by researchers of the value of IP emanating from their research, has also characterised itself in some of the most internationally cited and recognised patents emanating from South African institutions being sold to off-shore entities with very little returns to the country.

The IPR Act regulates IP developed by publicly financed institutions and small businesses (recipients) with public funds. There is considerable public funding on innovation, particularly by the DST, through instruments such as the Innovation Fund, the Advanced Manufacturing Technology Strategy (AMTS), Tshumisano Trust, and the Biotechnology Regional Innovation Centers (LIFElab, BioPAD, Plantbio, Cape Biotech, NBN), which will be migrated into the newly created Technology Innovation Agency (TIA) before the end of 2009. In the light of this public funding, the IPR Act is ideally positioned to emphasise the potential of IP to contribute to economic development, wealth creation and social upliftment in work to be funded by the TIA. The public is demanding more accountability by the public regarding government spending and the IPR Act plays an important role in ensuring such accountability.

So what does this mean for publicly financed institutions, and in particular, higher education institutions? Since IP is in essence property, the best way is to look at IP management practices required of the IPR Act as being similar to any prudent management practice in respect of property. Recognising that recipients are beneficiaries of public funding, the IPR Act gives the recipients the right of ownership to the IP, on the understanding that in the event that a recipient does not wish to retain such right, government may acquire such IP if this was in the national interest. Incentives for IP creators at publicly financed institutions for improved research practices and IP disclosure are entrenched through minimum benefit sharing arrangements. Institutions and IP creators may

negotiate and agree on higher benefit sharing. With the right to own IP emanating from their R&D activities funded with public funds, recipients have an obligation to ensure that such IP does not gather dust on the shelves but is commercialised so that the benefits flow to the broader society. In order to address the loss of IP to off-shore jurisdictions with little to no benefit to South Africa, the IPR Act lays down that certain conditions must be complied with before an exclusive licence or assignment of IP to an off-shore party can be effected.

Government now has a right to IP developed with public funds where this is required for the emergency needs of the Republic, in a manner that does not prejudice the recipients or licensees to such IP.

The IPR Act has established the National Intellectual Property Management Office (NIPMO). NIPMO's primary purpose is to ensure effective implementation of the IPR Act through appropriate capacity development, advisory services, funding of IP costs, exercising public rights in respect of IP governed by the IPR Act, and regulatory measures required in terms of the IPR Act. NIPMO will assist in the establishment of Offices of Technology Transfer, and where such offices exist, NIPMO will, as needs dictate, provide support and work with such offices to inculcate best practices in IP management and commercialisation.

The effective implementation of the IPR Act should result in increased awareness of the value of IP and lead to improved IP management and commercialisation practices throughout the country. For the institutions, this may mean increased stature in respect of research practices. It will also add economic relevance to such research. This act has the potential of spurring a number of economic activities, including new technology-based start-up businesses, higher out-licensing revenues, employment opportunities and increased R&D activities. This will ensure that IP emanating from public funds contributes to economic activity in the country.

About the author

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2. IDEA TO PATENT

A BRIEF INTRODUCTION TO PATENTS



Sandra Clelland

What is a patent?

A patent is the instrument that is used to protect an invention. It is issued by a Patent Office to prevent inventions being copied and reproduced. The State allows inventors to secure protection for their inventions provided that the inventor discloses the details of the invention to the Patent Office.

The document that describes the invention is referred to as a patent specification. It not only describes the invention but also defines the specific features of the invention that enjoy protection. These features are defined in a series of statements called the patent claims.

A patent right is restricted in a number of ways:

- It is limited to the countries in which patents are filed. There is no such thing as a worldwide patent.
- It is limited to a maximum period of 20 years, subject to annual fees being paid to keep the patent in force.
- The claims define the specific features of the invention that enjoy protection. Anything that has these features would infringe the patent. A commonly held misconception is that

by simply making cosmetic changes the patent can be avoided. This is generally not the case and the differences have to be more fundamental and well thought through to avoid patent infringement.

Once a patent is secured in a particular country, the owner of that patent has a monopoly that allows the owner to control a range of commercial activities relating to that invention.

The control that can be exercised includes:

- the making of the invention;
- the using and exercising of the invention; and
- the sale, licensing and leasing of the invention.

What is an invention?

An invention can take a number of forms, such as a process, a method, a machine, a device, a new material, a chemical compound, a chemical composition or a new nucleic acid sequence. In fact, anything which meets three criteria defined by patent legislation can be considered an invention.

These three criteria are:

- The invention must be new in that it is not previously known anywhere in the world.
- The invention must not be an obvious variation on known technology.
- The invention must be capable of being applied in trade, industry or agriculture.

If an invention meets all of these criteria, it is patentable, save for a few exceptions, such as abstract ideas, natural phenomena and laws of nature.

Even though a previously unrecognised substance occurring in nature may be regarded as a mere discovery and not an invention (such as a new microorganism, an active compound in a plant or a gene sequence), if the substance can be shown to produce a technical effect, then it may be patentable in many countries.

Prior art

Searches are often conducted to determine if an invention is new. The aims of the searches are to identify what is referred to as 'prior art', which is technology or similar inventions that predate the invention. Identifying this prior art is a critical step in determining whether or not an invention is patentable and whether meaningful patent protection can be secured for the invention. These searches can be done using a number of different sources. These include:

- the inventor's knowledge of his or her field of work;
- the Internet;
- keyword searches on Patent Office databases;
- paper-based searches at Patent Offices; and
- technical literature.

These different types of searches vary in complexity, reliability and cost. It is the interplay of these factors that determines the selection of the type of search.

The patenting process

Patent rights are ultimately secured by filing a final or complete patent application in every country where patent rights are being sought. It is in the steps leading to the filing of this final application where flexibility exists in the process. In general, there are three routes that are followed:

- File the final application immediately, without filing earlier patent applications.
- File a provisional application to establish a filing or 'priority date', with the final application being filed within twelve months of the provisional application.
- If the patent is to be extended to foreign countries, the Patent Cooperation Treaty (PCT) is often used. This allows the same application to be filed in more than one country at one time.

Combinations of these processes are also used. The important features of any patent filing program is to secure a priority date by way of the first patent filing (whatever form this takes) and then from this date to ensure that time periods are met and observed in each step in the patenting process.

Patent prosecution

Once a final patent application has been filed at a Patent Office, it is subjected to examination. The level of this examination varies from country to country. Some countries only review the documents to ensure that formalities have been complied with (these are so-called 'non-examining countries'), while other countries consider the inherent patentability of the invention relative to earlier inventions and prior art (so-called 'examining countries'). The examination and interaction that goes on with the inventor during this phase of the patenting process is referred to as 'patent prosecution'.

Based on the outcome of this examination, a decision is made to either grant or reject the patent application. If the application is accepted, the patent is granted and advertised in a patent journal or database.

To patent or not to patent?

Once an invention has been developed, a decision has to be made whether or not to protect it by way of a patent. There is always an option not to file a patent application and to protect the invention by way of confidentiality. This may be an appropriate strategy to follow in certain circumstances. However, this can only be done if the confidentiality of the invention can be preserved and the invention does not become self-evident from the product or process that is sold or used commercially. It is also not an appropriate strategy to rely on confidentiality where the intention is to license or sell the invention. This is because patents are tradable forms of protection, while it is more difficult to license or sell confidential information and know-how.

It must be stressed that even if it is decided to file a patent application, it is important to keep the invention confidential, at least until the application has been filed. The reason for this is that any prior disclosure of the invention can be used to invalidate the patent application. All forms of non-confidential disclosure must be avoided, including the sale of products using the invention, the implementation of any process invention on a commercial scale, the publication of articles about the invention or giving presentations at conferences or to prospective customers and commercial partners.

Once the patent application has been filed the invention can be disclosed to others without prejudicing the patent.

Provisional or complete patent application?

Once it has been decided to apply for a patent, a further decision must be made whether to file a provisional patent application or a complete (final) patent application. Many inventors choose to follow the provisional patent route for a variety of reasons:

- There are fewer formalities involved with a provisional patent application and it can generally be filed more quickly than a final patent application.
- A provisional patent application is cheaper than a final patent application. In order to secure patent rights, a final patent application will ultimately have to be filed, but a provisional patent application is a cheaper way of entering the patent process.
- Developments and improvements to the invention that are made after the filing of the provisional patent application can still be included in the final patent application. This is more difficult and there are more restrictions if the first application is also the complete or final patent application.
- The provisional application protects the invention for a year before further patenting steps must be taken. This year can be used to do development work, conduct market trials, negotiate with investors to fund the commercialisation of the invention and to perform patent searches to establish whether meaningful patent protection will be obtained for the invention.

What information do I need to give my patent attorney?

Before preparing a patent application the patent attorney will interview the inventor so as to understand the invention and all its features. It is useful to compile a description of the invention before going to the meeting with the patent attorney. This can often be made easier by using a drawing cross-referenced to the description. A well-compiled pack of information will certainly speed up the process and this will ultimately save costs. In compiling the description of the invention it is also useful to include details of other inventions in the relevant field of technology, particularly if the invention has advantages over the existing technology. Highlight these advantages and improvements.

Foreign patent applications

During the patenting process a decision must be made whether or not to secure patents in foreign countries. Bear in mind that a patent that is granted in South Africa will only provide patent protection in this country. There is no such thing as a worldwide patent.

Patent Co-operation Treaty applications

A Patent Co-operation Treaty (PCT) patent application does not result in an international patent being granted. It is merely a patent filing system that allows the inventor to delay the filing of national patent applications. National patent applications will ultimately have to be filed in each country where patent rights are to be secured.

The PCT process delays this decision and gives the inventor time to test the invention, raise capital and decide in which markets the invention is likely to be successful. The PCT patent application must be filed within 12 months of the provisional patent application or the first patent application for the invention. The PCT process then allows the inventor to delay the filing of national patent applications by a further 18 months. The PCT process offers other benefits:

- The process offers the option of having the patent examination subjected to a comprehensive search and examination process. This provides a good indication of patentability of the invention before substantial costs are incurred by filing national patent applications.
- Amendments can be made to the application before the national patent applications are filed. Once again this saves costs during the national patent filing phase.

Conclusion

Patents are a wonderful way of securing and protecting the rights in an invention – and hence its value. The patenting process, however, requires that a number of decisions be made, based on a carefully considered patenting strategy and supported by a sound patent application.

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A STRATEGIC APPROACH TO PATENTING



Ralph van Niekerk

Today, more than ever, intellectual property rights form a significant part of the balance sheets of many businesses. These intellectual property rights include unregistered rights which arise automatically – such as copyright, goodwill, trade secrets and know-how – as well as registered rights, such as patents, registered designs and trademarks. In the case of patents, deciding whether and how to develop a portfolio of patents is an important business decision. While many companies acquire patents in a haphazard manner, unlocking the full potential of patent rights requires a strategic and structured approach.

A patent is a limited monopoly that is granted by the State to an inventor in exchange for a full disclosure of the invention. A well-drafted patent for an important technology provides the patent owner with the right to exclude its competitors from using the invention in any practical way for the duration of the patent, which is usually 20 years from the date of application.

As an initial step, ask yourself why your business is considering acquiring patents. There are several purposes for which patents can be acquired, and which can be classified as either offensive or defensive patenting strategies.

Offensive patenting strategies

Excluding competition

Patents can increase barriers to entry and prevent competitors from copying protected technologies by forcing them to design-around the patents. How effectively your competition can be foreclosed from competing with you depends on how much of a breakthrough your technology is and how effectively your technology is protected by your portfolio of patents. Sometimes the mere existence of a large portfolio of patents covering many aspects of a key technology can be enough to deter competition or leverage a favourable licensing arrangement with your competitors.

Licensing

Another offensive patenting strategy involves licensing. This strategy grants the competition the right to practice the invention in exchange for royalty payments. Without a patent in place it is normally very difficult to licence technology as the only thing that can be licensed is confidential information and know-how. Confidential information and know-how can very easily pass into the public domain after which there is nothing to license. With patents it is simple to license all or part of the rights to other parties. Patent licenses can be restricted to specific geographical areas, fields of technologies or time limitations. This protects the patent owner's competitive advantage in its chosen market and simultaneously unlocks other markets.

Successful businesses exist that do nothing but develop technology, patent that technology and license its use to others in exchange for royalty payments. An example is the 'fab-less' U.S. chip manufacturing company Rambus, which develops new semi-conductor technology and then licenses it to semi-conductor manufacturers like Intel and AMD. Universities are also examples of entities that generally patent technologies exclusively for generating licensing income rather than for exploiting the inventions themselves.

Companies can choose to license their core technologies and avoid the set-up cost of developing their own manufacturing facilities, or can license their peripheral or ancillary technologies to parties that are better positioned to exploit them. IBM is an example of a company that files many thousands of patent applications each year for technologies

unrelated to their main business and then packages and licenses these patents to companies interested in exploiting them.

Increase shareholder value and attract investment

Investors like to see company technology protected by patents because these assets can be leveraged as the company grows. Patents also indicate proof of ownership of technology and validate the originality of inventions. Many investors use the size of a company's patent portfolio as an important company valuation measure. A significant patent portfolio will impress potential investors and reassure existing shareholders.

Defensive patenting strategies

Freedom to operate and business negotiations

There are many markets in which doing business without patent protection is extremely risky. This is particularly true in the United States, where patent owners tend to be very litigious. Without a credible counter-threat of infringement, companies with no patent protection can be forced out of the market by threats of infringement. Having a well-developed portfolio of patents provides flexibility in business negotiations as disputes can often be settled amicably through cross-licensing arrangements.

Patents can also provide a shield against competitors obtaining similar patents, because unlike trade secrets or confidential information, patents become prior art after they have been filed. This prevents the competition from getting protection for the same invention.

Insurance value

At an early stage of the technology development cycle it is often unclear as to what the end result of any particular invention will be. If the technology is disclosed then it falls in the public domain. A cost-effective way to ensure the possibility of following one of the options mentioned is to file a provisional patent application before the invention is disclosed to the public. In this way a provisional application can be thought of as being similar to taking out insurance. It may, for example, happen that a provisional patent that was filed simply as insurance, turns out to be very valuable with huge licensing opportunities. Remember that further patent applications based on a provisional patent application must be filed within one year, or the provisional application will lapse.

Company flexibility

During the development of technology and the expansion of a business there may often be a change in business circumstances that requires a change in approach. Having a patent portfolio that is wider than just your key business provides the flexibility to quickly enter new markets and create new products.

Setting a budget and monitoring the portfolio

Once the purpose for acquiring patents has been identified, a realistic budget must be set. As a rough rule of thumb, many businesses spend approximately 10% of the total R&D costs on patenting their inventions. While this may seem like a sizeable sum, remember that without patent protection you may find that you are unable to carve out an exclusive market or obtain licensing revenues, and competitors who have not incurred the upfront R&D costs may be able to drive you out of the market for your own technology by competing on price alone.

If you are a small company with limited resources looking to attract investors, it will probably make sense to focus your patenting efforts on key technologies. Larger, well-capitalised companies may choose to try and erect barriers to entry and acquire patents for ancillary technologies that can be licensed.

Once you have more than just a few patents, it is important to measure the results of your patent expenditure against its cost. It is also important to continually re-evaluate the patenting strategy to determine whether or not it is still in line with your ultimate purpose, whether that is to secure funding, obtain licensing revenue, create new markets or prevent the sale of competing products.

About the author

Ralph van Niekerk is a partner in the patent department at Von Seidels IP Attorneys. He holds a B.Eng degree from Stellenbosch University, an LLB from Unisa and an LLM from Stanford Law School.

Ralph's expertise includes the preparation and filing of local and foreign patent applications, especially electronic- and computer-related inventions, registered design application drafting, patent and general intellectual property litigation, the drafting of patent infringement opinions and the drafting of patent licence agreements. He also spent a year studying and working in the field of intellectual property in the United States and is familiar with the US IP system.

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3. PATENT TO MARKET

CHALLENGES OF CONVERTING RESEARCH OUTPUT INTO A COMMERCIAL PRODUCT

*How to survive and
approach the gap
between research and
commercialisation*



David Weber

Of all the crazy things you can do, trying to convert some idea into a successful commercial product just has to be one of the craziest. It is one of those things that you would never do if you knew just what it was going to take to get it right. This being said, success is rather sweet – and success happens. And if you succeed, you get a license to tell people like me ‘I told you it would work!’ and then flaunt your Porsche shamelessly. Note that I used ‘and’ between the taste of success and the rewards. Success in commerce is very different from success in academia. Academics measure success in journal papers, research grants and kudos from other researchers. In commerce, it is measured in the degree to which the product’s assets exceed its liabilities. And this means that not only is there a market for the product, but that it is suitable for that market, that there are no entrenched incumbents catering to that market and that the market has sufficient size to justify the expense of development.

One of the best ways of looking at how a product can develop is to study how things will look at the end of the entire commercialisation process. At this stage, the market will clearly understand the value that your product adds to their businesses and lives and will be happy to pay you a fraction of the value that you added to them. Your product is the dominant player in its niche and competitors are watching you with envy. And

rather critically, the market is big enough to make it attractive. You won't be able to get precise answers when you start on the process of commercialisation, but you should be able to get some idea of market size and the competitive landscape without a major investment. The earlier that you consider (apparently) mundane details, such as who is going to buy this and why, the better off you will be. And one can achieve a great deal of market knowledge with relatively little effort.

I am going to assume that whatever your research has delivered, it is a very clever scheme and that it works fiendishly well – at least in the laboratory. And you think there is a market because you tried to make the work commercially relevant. So how do you proceed? Whatever route you follow, you will have to have good answers for the following questions:

- **What value does it add?** Can you quantify what a user of your device/system will gain? A good rule of common sense as a buyer is that the cost of the device must be a fraction of what it is going to save the buyer. A compact fluorescent bulb costs way more than an incandescent equivalent, but it is frugal on power and lasts for ages. This is compelling, especially if a 300 kg gorilla like Eskom is pushing for it.
- **How big is the market?** Here we mean how much money is available in the market for your product, not how many you will sell. Low volume niche products can have huge markets. You need to have a good idea of what type of people and enterprises will buy your product and why. Remember that they are not going to break down doors to get to your product, so be realistic.
- **Who are the competitors?** I often hear people say that 'we have no competitors'! You always have at least one competitor – apathy. It is usually easier to just go with the status quo than it is to adopt something new and complicated. As well as this thorny competitor, you may be facing an incumbent or two. Not that this is a disaster; you must just be sure that your offering is compelling enough to dislodge them. Microsoft pushed IBM out the way, something that seemed totally impossible at one time. However, pushing Microsoft out the way will require a rather cunning plan. Use Google, search patents and ask people. Remember that investors can also use Google and will be disinclined to back you if you have made an obvious oversight in the competitive analysis.

- How much will your device cost to produce and maintain? We could be talking about a new type of cork for a wine bottle, or we could be talking about a new kind of electric power station. This does not change anything, as cost is important. Be realistic, as commercialisation is an expensive process and is very different from research.
- What are the risks associated with your product? You need a very clear understanding of what still needs to be refined and what can go wrong, both technically and commercially.
- How will the development process look? Do you have a plan on how to continue development and do you know what it will cost?
- What is your product vision? How will things look when you have conquered the world (or at least some small part of it)?
- What next? Any product has a lifespan in the market (ask Kodak about wet photographic film), so what can you start researching now in order to keep you competitive in five years' time?

You can summarise all this in a prospectus or a business plan. Short documents are always better than long ones. You will need something when you knock on InnovUS's door, or else you will just be given this brochure again and be sent back empty-handed.

So now you that you are armed, you are ready to proceed down the path of commercialisation. What do you do now? There are many routes to follow, but all of them will require an investor of some sorts. The act of turning an idea into a research output was also an investment. This investment is usually made by the Government through some grant or even by the university itself. Just the fact that you have a lab and electricity implies someone invested in infrastructure for you. So investors come in various flavours, and I can promise you that none of them are in it for the pleasure of throwing money away. So let's take a brief look at what you can expect to find.

- **Angel investors:** These are private individuals who are prepared to take a bet on you. It could be family, a friend (careful here) or even a professional angel investor. They will want to take shares in your company and see a return. They are often prepared to provide seed and early stage funding, which is very useful.
- **Venture capitalists:** These are useful entities that are (at least in this country) only really interested in investing in businesses that are cash

positive (this is a long way down the road from a scruffy prototype on a researcher's bench) and can show a significant market. There are very few that provide seed funding as it is a good way to lose money. And yes, they will want shares in your company.

- **Government schemes:** There are several government schemes that are designed to stimulate innovation out there, including the SPII funding scheme, the Innovation Fund and various other stimulus packages. Use them by all means. Just remember that they need masses of paper work and can be a little inflexible at times. And don't be surprised if they look for some shares in your company. After all, they need to generate revenue for other investments.
- **Yourself:** Self investment is very common. Most people who follow this route will consult or do contract work and invest spare time and money into their product. It works, but it is slow. At least you get all the shares.
- **Private equity and stock markets:** These are for the bigger, more established players, but essentially they provide enterprises with cash in exchange for shares.

I am sure that there are other variations on these, and I am also sure that in the lifetime of the business you may draw on more than one of these types of investors.

There is one important consideration that many people in academia overlook. The commercial world is a different place from a university. It is big and brutal and does not always work by common sense. It relies enormously on human interaction through social networks and changes very slowly. Naivety is a common problem and you would do well to consider your position in the bigger scheme of things:

- You are probably very clever, but you are not the only clever person out there. I can guarantee that someone somewhere has already tried to do what you are doing and that someone has tried to commercialise it, or at least thought carefully about it. You need to really check out what is going on in the world in your field before you start your research.
- The commercial world does not really care about cool. Your invention may be wickedly cool and remarkably ingenious, but nobody is going to give it a second look as an investor just because it is cool.
- Creativity is scarce. Creative people with good brains and who work in an environment that fosters innovation are scarce. Use your privilege

to the limit to open up new ways of doing things and always pick the road less travelled. It is what you have to offer the commercial world.

- Complex and intricate schemes are more difficult to commercialise than simple and elegant schemes. A Rube Goldberg machine for boiling eggs will never beat a simple pot on a stove, so strive for simplicity, not complexity.
- The world does not owe you anything. If anything, you owe the world a fair bit, at least for your education. Success implies monstrous quantities of work, ingenuity, investments and a pinch of luck and it eludes most who seek it out. Automatic backing and success is not a right that you are entitled to.
- As wicked as your research is, it is just a very small step along the way to commercialisation. Even a production-ready device is a long way from successful commercialisation. While technology is a critical driver of success in the market, it is generally easier to develop than it is to open up a good market segment and sell to it.
- People often have very high expectations of what they are worth in these deals. At the end of the day, you may be able to get a 3% royalty for a patent if you just license stuff. Or you may end up with a percentage of a company which commercialises the product. However, when all is said and done, you are unlikely to own even 25%. The value of an idea or a research output is rather low if you are not prepared to back it up with some damned hard work and take some significant financial risks.

Right, so what do you do next? At Stellenbosch, you are lucky enough to have an intellectual property office which can make deals and guide you in the process. And believe it or not, they are on your side! They have a mandate to look after the intellectual property developed at the university and see you as a good way to get the most out of it. So take your idea and summarised business plan to them. They can open doors and introduce you to various organisations that will be interested in what you have to offer. However, always remember that while they may help you open doors, you have to walk through the door yourself.

About the author

David Weber is the Chairman of Stone Three Venture Technology (high-tech product development), as Director of Acom, a private equity investment company. His primary responsibilities are at Acom. He holds a PhD in Electrical and Computer Engineering from Carnegie Mellon University. When not dreaming up technology solutions or buying and selling companies, he rides his mountain bike, runs on mountain trails and maintains his private pilot's licence.

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3.1 Licensing your Patent

THE NEW WAY OF FINDING THE RIGHT INDUSTRY PARTNER



Nicolas Lategan

If you could line up all the American people from the most to the least intelligent, and then add up the most intelligent 15%, you would get a total which is about the same as the top 4% in India, or top 3.5% in China. However, that same number of people would be more than the total South African population! Or if you think you're one in a million, it implies in India alone there are 1,100 people just like you.

'So what' you may ask. The fact is that if we think that we have sufficient expertise in our companies to keep us globally competitive over the next ten years, we may be entirely wrong. There are probably more people outside our company better skilled at what we're doing than within our company. This has led to a new research and development (R&D) practice where external technology is used along with internal R&D, and has been coined Open Innovation. This trend has already been embraced by more than 50% of the Fortune 500 companies.

Open Innovation initially emerged when companies started promoting their intellectual property to one another for licensing. Companies found that they could actually make money by licensing to their competitors, or to companies in other geographic areas or outside of their core industry. Once this happened, it was a natural progression to start promoting specific technology needs in the hope that someone else might have the applicable

technology to solve the need. The benefit of this was that the company seeking the technology could evaluate various potential solutions and only license those that appeared to offer the best solution.

Often this technology was already patent protected, which limited their risk, was close to market and cost them much less to license than to develop.

Impact on South African inventors

Globally companies are now seeking inventions, new technology and breakthroughs. They are open for partnerships in developing promising new technology. Open Innovation intermediaries like Yet2.com and IdeaConnection make it possible to expose new technology to hundreds of companies across the world. We often find that companies that respond to new technology offerings were not even considered a target industry by the inventor. This cross-application of technology is an exciting development offered by Open Innovation and plays a major part in selecting industry partners. Your ideal partner may turn out to offer a high-value niche opportunity that is much closer to profits compared to mainstream market opportunities.

This means you can now expose your technology internationally, find an international industry partner, and once the technology are ready for commercialisation, you already have an international channel and partner established.

About the author

Nicolas Lategan is the founder and CEO of Licensing Technology Network, an organisation which focuses on marketing South African technology to facilitate license deals with international and multi-national companies. He is also the South African agent for Yet2.com, the world's largest open innovation technology transfer company, as well as for Lambert & Lambert which specialises in consumer products. Nicolas holds a MBA from Stellenbosch University.

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LICENSING TECHNOLOGICAL DEVELOPMENTS FUNDED BY PUBLIC MONEY



Roux de Villiers

Like other universities around the world, South Africa's institutions of higher learning have a focus on research and study which can result in the creation of marketable new technologies. But when technological developments emerge as the result of the investment of public money, what becomes of them? This is a question which government sets out to answer with the promulgation of new legislation that provides a framework for the commercial exploitation of this sort of intellectual property.

Draft regulations dealing with this issue have been gazetted (Government Gazette 32120) under the Intellectual Property Rights from Publicly Financed Research and Development, 2008 (Act 51 of 2008). Once a new development has resulted, the individuals involved in the research, and the university itself, have an interest in enabling its commercial exploitation. Government, too, has an interest as it stands to gain in terms of tax income on sales which may result from that exploitation.

However, universities are not geared towards commercial exploitation, but are rather focused on the research and possible development aspect. This necessitates the identification of a suitable partner that has the market reach and capability to take the new technology, develop it into a commercially viable product or service and then market that product or service as broadly as possible in order to generate an income from it.

That partner needs to be chosen very carefully; indeed, the Act sets some conditions that must be fulfilled when choosing that partner, including a preference for a local organisation. While historically, South African institutions have often tended to opt for an international partner, government appears to be clamping down to some extent on the practice. The Act tells us that it is necessary to look local first, since with the transfer or exclusive licensing of intellectual property rights to a foreign organisation, some of the taxable royalties and developmental opportunities may leave the country.

In this regard, approvals may be required from Treasury, as well as from the National Intellectual Property Management Office of the Department of Science and Technology. The difficulty is that the selection of a local partner may result in severe limitations in the potential market reach for the technology. That may be addressed through licensing the technology to several partners, but this is not an ideal solution; exclusive agreements are preferable from a commercial aspect, despite the Act pushing for non-exclusivity. This is because the partner will typically have to invest substantially to ready the technology for revenue generation and to market it; it will therefore look for some sort of guarantee, such as exclusivity, to ensure that its risk results in a return.

Structuring royalties

The next issue that arises is how to structure royalties in terms of the licence agreement. Experience advocates the payment of an upfront fee with recurring royalties on sales generated in due course. The reason is that there should be an opportunity cost which places a pressure on the partner to make the most of the opportunity. If there is no risk, there is little incentive for the partner to immediately turn its attention to development and commercialisation of the technology. The university, government and individuals involved in the discovery of the new intellectual property, should then enjoy an ongoing share in the success of its commercialisation.

Furthermore, the licensor (the university/government/individuals) should exercise some control by way of an agreed business plan with which the licensee (partner) takes the technology to market. This is another guarantor of the sustained effort of the partner to generate revenues and profits from the development of the technology. In terms of this, objective milestones should be put in place against which progress can be measured, failing which certain consequences could result, including

the potential loss of exclusivity. In such a case, the partner may license the technology only to shelve it as the result of commercial decisions to develop other opportunities first. If it is an exclusive partnership, this can result in the technology becoming worthless. Simply put, there should be adequate 'carrots' (incentives) and 'sticks' (punishments) to keep the partner motivated and performing.

Assuring further development

Since universities are public institutions and the lecturers and researchers working there are subsidised to do their work and incentivised to publish their findings, a dichotomy arises in terms of which the partner has an interest in maintaining secrecy around the technology it has acquired, while the lecturer will likely seek to continue publishing papers.

The license agreement therefore has to deal with this dichotomy effectively, making provision for exclusivity on the licensed technology and allowing for continued research. In terms of this, the license agreement must include exceptions on exclusivity to allow continued research and the publication of subsequent findings. These clauses must provide for how the university will publish and how it will be incentivised.

Leading on from that is the question of how new uses for and improvements to a licensed technology will be handled - do they accrue to the same licensee or can the university use them as it wishes? This must also be considered by the licensor and licensee in the license agreement.

The bottom line is that the licensing of publicly funded technological developments is a complex and sensitive issue. It has a number of vested interests which must be carefully considered in a fair and balanced license agreement which provides for the optimal exploitation of the technology for both public and private commercial benefit and which ensures that such licensing is compliant with the applicable regulatory frameworks.

About the author

Roux de Villiers is a director at Werksmans Incorporating Jan S. de Villiers. He holds an M.Eng in Electrical Engineering and an LLB from Stellenbosch University, as well as an LLM in Computer and Communications Law (London). He was previously admitted as a Solicitor to the High Court of England and Wales and his field of expertise includes telecommunications and IT outsourcing agreements, software development and licensing and software resale.

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CHALLENGES OF COMMERCIALISING YOUR IP OUTSIDE SA BORDERS



Anthony van Zantwijk

The challenges

International IP transactions are more complex than domestic transactions due to the application of different laws, taxes and exchange controls, and complications relating to enforcement.

Domestic laws

At the very least, international agreements should comply with the applicable laws of both contracting parties. To illustrate, when contracting with a US entity, beware of the doctrine of Abuse of Rights and the potential that significant product liability claims may be directed at the licensor. You must also consider the other countries' Competition Laws. Many 'common provisions' in South African contracts contravene the European Community Competition Law, such as requiring the licensee to assign any improvements to the licensor, or restraining the licensee from challenging the validity of IP licences. The EC requires that know-how licences detail the know-how in a schedule and proscribes restrictions on the sale of licensed products to select countries within the EC.

Furthermore, do not assume that all IP laws are similar. For instance, our law relating to joint ownership of patents is reflected in the laws of the Province of Quebec only. As a general rule, whenever IP is jointly owned, regulate rights by way of a comprehensive joint ownership agreement.

Tax implications

Too many international IP transactions are concluded without considering potential tax implications. Here are some examples:

- International royalty payments are typically subject to withholdings tax at varying rates depending on Double Tax Agreements. South African licensors should be sensitive to royalty receipts from countries such as Botswana, as South African tax credits are not available for all withholdings taxes paid in such countries. Also, remedying this imbalance by defining royalties as 'net of withholdings tax' is generally not permitted.
- South African licensees should generally avoid paying 'licence fees' (upfront payments, lump-sum payments), as these are often not tax deductible by the licensor. If upfront payments are necessary, provide for an 'initial term' and 'renewal terms', as corresponding deductions will otherwise be spread over 25 years.
- Where the parties to a transaction are 'connected persons' (which definition varies from country to country, but in terms of our Income Tax Act includes companies connected by 20% shareholding) the transaction must be concluded on 'arm's length' terms. For this reason, foreign subsidiaries are seldom entitled to use IP of a South African parent royalty-free.
- South African taxpayers conducting R&D outside South Africa are typically denied tax deductions for related R&D expenditure. On the other hand, where a UK entity contracts a South African entity to perform R&D, it is sometimes possible for the R&D expenditure to be funded substantially from generous R&D tax incentives (175% in the UK plus a 50% 'top-up' in South Africa – a rare example of legitimate 'double-dipping').
- Royalties paid to a foreign licensor are not deductible where rights have been 'exhausted' by the supply of the licensed product. And, where an exclusive licence has been concluded between a South African licensee and a foreign licensor, at least 25% of royalties paid by the licensee may be denied deduction by SARS on the grounds that such expenditure is 'capital' in nature.
- Payments associated with intellectual property previously owned by a South African tax resident may be denied tax deduction if caught within the scope of new section 23I ('Licensing Arbitrage') of our Income Tax Act, which came into effect on 1 January 2009.

- Payments relating to royalties, technical services, supply, and such like, should not be 'rolled-up'. Many of these payments are subject to different tax treatments, so keep them separate.

It is common for transactions to be restructured while navigating one's way through the tax acts of both countries - and we have yet to touch upon exchange controls.

Exchange controls

Generally speaking, our exchange control regulations require contracts that include any of the following 'tainted provisions' to be submitted to the Department of Trade and Industry/South African Reserve Bank for prior approval:

- Assignment of IP by a resident (a South African) to a foreigner. In this regard, consider improvements clauses in 'incoming licences' (licences concluded between a foreign licensor and a resident licensee).
- Concluding an arrangement whereby IP is jointly owned by a resident and a foreigner.
- Payment of royalties by a resident to a foreigner. As a rule, avoid 'minimum payments' as they are seldom approved by the SARB.
- Grant of a licence by a resident to a foreigner at a discounted royalty rate.
- Grant of a licence by a resident to a foreigner coupled with the right to sublicense enabling the foreigner to retain a royalty spread (for example, a foreign licensee receives 7% royalty from a sublicensee and pays 5% to the resident licensor, thereby retaining a 2% spread).
- Cession of IP by a resident to a foreigner as security.
- Extending financial assistance to a foreigner for a period exceeding six months (for example, providing for annual royalty payments).
- Permitting a foreigner to institute infringement proceedings in respect of a resident's IP and to retain any damages awarded.

Remember that the contravention occurs when a contract that could result in any of the above is concluded. It is the signature of the agreement and not the expatriation of the asset/property that is

unlawful. As such, suitable suspensive conditions should be included in contracts containing 'tainted provisions'.

However, the Reserve Bank policy is to refuse assignments to a 'related' foreign assignee (even for market-related consideration) and to deny any foreign assignee the right to license the IP back to a resident in consideration for royalty payments - and the interposition of trusts does not assist.

Enforcement

Finally, always consider enforcement. If Party X is more likely to breach the contract, consider which courts will enjoy jurisdiction to hear the matter. If Party X has no assets in South Africa, it is unlikely that action can be instituted in our courts. Therefore, do not select South African law as the 'governing law'. To ameliorate the problem, consider inserting arbitration provisions.

About the author

Anthony van Zantwijk is a partner at Sibanda & Zantwijk Attorneys, where he practises as a patent attorney and a tax advisor. He studied Civil Engineering at the University of the Witwatersrand, before obtaining LLB and LLM degrees from the same institution.

He qualified as a patent attorney in 2002 and subsequently worked in the Special Projects department at the South African Revenue Services (Large Business Centre, Johannesburg) tackling intellectual property valuations, tax issues relating to intellectual property and structured finance transactions. Despite returning to private practice, he remains involved in assisting the South African Treasury to regulate the dynamics between IP, tax and exchange controls.

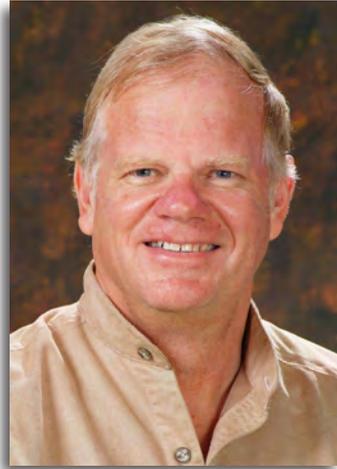
Anthony also lectures the IP Tax module for the Wits HDip (Tax) course and the IP commercialisation and valuation modules in the Wits LLM (Intellectual Property) course.

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HOW TO WRITE A BUSINESS PLAN



Wynand Coetzer

3.2 Spin out Company

Aim of the business plan

Before you start writing your business plan, you should be clear about who you want to read it and what you want to achieve with it. We discuss the issue from the point of view of a start-up company that wants to attract an investment.

Structure of a business plan

A business plan should have a clear and logical structure. If an investor stops reading, all your effort has been in vain. We propose the following outline:

1. Executive summary
2. Brief explanation of the innovation (product or service)
3. Market analysis
 - a. Business models
 - b. Market segments
 - c. Portfolio analysis
 - d. Market research
4. Strategy
 - a. Risks
 - b. Marketing strategy
 - c. Organisation strategy
 - d. Financial strategy
5. Conclusion

1. Executive summary

The executive summary should summarise the salient aspects of the plan. Anybody reading the summary should know what the outcomes are and should only need to read the main body of the plan if the details are required.

2. Innovation

This is a brief description of what your envisaged product or service is. Do not include detailed technical information here, but focus on benefits to envisaged users. What is innovative about your offering? How will it benefit potential users? What do they currently do without your innovation? What is the problem with current offerings? Why will your innovation be compelling to them? How will you be able to protect your intellectual property?

3. Market analysis

A large part of this section is taken from Engineering Entrepreneurship – Steering Start-ups to Steady-State by Wynand Coetzer. Due to space limitations only a summary of the main steps required can be discussed here.

You need to take the following steps for a market analysis:

- List a number of business models;
- Do a market segmentation on these models;
- Do a portfolio analysis.

3a Business models

A business model is basically an answer to the question: 'Who will be willing to pay for our offering and what do they need it for?' The most important thing to keep in mind is to look at it from a user perspective.

3b Market segments

The following steps will help you to identify market segments. These steps ensure that the least amount of effort and market research are needed:

- a. Make a list of about seven key user needs per business model (KSFs).
- b. Make a list of all possible pairs of (most important, second most important) KSFs.

- c. Group users into one of these pairs of KSFs and look for common features in every group. Each such group is a market segment, i.e. a group of users with the same needs.

3c Portfolio analysis

Determine the attractiveness for each market segment (high, moderate or low) as well as your competitiveness in each segment (strong, moderate or weak). Plot the results on a portfolio diagram and ascertain if there is at least one highly attractive market segment in which your product will be strongly competitive. If there is such a segment, complete the rest of the business plan for it; if not, keep on analysing more market segments and/or business models until such a segment is found. Do not even think of entering a market segment that is not highly attractive or in which your product is less than strongly competitive.

It is extremely dangerous to guess attractiveness or competitiveness. The results obtained by guessing are invariably wrong. You should follow the structured approach explained in the previous paragraphs.

3d Market research

All results above should be supported by relevant market research with potential or actual users. Follow the structured approach explained in the previous paragraphs for the minimum market research needed to ensure accurate analysis results.

4. Strategy

The following paragraphs briefly discuss the issues that you should address in your strategic plan.

4a Risks

What risks do you foresee? How probable are they? What could happen if these risks materialise? How would this affect your plans? How do you plan to address these risks? How would you determine whether these risks can be successfully addressed as soon as possible?

4b Marketing strategy

A marketing strategy addresses the so-called 4Ps, namely Price, Product, Promotion and Place (distribution). What is of particular importance is to determine the price. Do not follow a cost-plus mark-up approach. Determine your offering's value to users and base the price on that.

4c Organisation strategy

A start-up usually consists of a small team of people. Present your team and each team member's qualifications, role(s) and responsibilities. Explain how suitable each person is for the job, what gaps exist in the team and how you plan to address the gaps.

If there are other organisational issues, for instance the need for a factory, describe it here. Also give information about crucial partnerships.

4d Financial strategy

A financial strategy consists of the investment decision, the financing decision and the dividend decision. The investment decision concerns the opportunity addressed in the business plan plus the expected return on investment. This is exactly the place where most business plans for start-ups fail completely – when they include cash flow projections. By the nature of a new market (and a start-up should only consider new markets), future cash flow is impossible to predict accurately. Rather do the following:

- a. Do an analysis of the profitability on the upside (when the business is successful one day). This gives an investor an idea of the eventual return potential.
- b. Motivate the current investment needed and what will be achieved with it. Explain carefully what further investments remain to be done after this one. Be frank. Investors are not stupid. They will figure it out any way so it is better you tell them up front.

The financing decision involves how you plan to pay for the investments needed.

- a. Explain the investment needed currently and what you offer in return.
- b. Explain how you plan to raise any further investments needed.
- c. It takes time to penetrate a market and build up an income stream. The bad news is that it is impossible to predict how long it will take for a start-up. Draw up a budget to show how you will become indefinitely sustainable after this investment. If you do not have such a plan, go back to the drawing board until you have.
- d. It is best to summarise the financing part in a budget.

The dividend decision is a plan of how to distribute future free cash flow to shareholders. If this investment opportunity promises early free cash

flow, this is the place to highlight it and explain the dividend philosophy, for instance, whether the company plans to pay it out as dividends or whether it plans to invest it.

5. Conclusion

This is merely a brief introduction to the structure of a business plan. For further details please consult my book. Engineering Entrepreneurship – Steering Start-Ups to Steady State and consult any investors that you plan to target regarding their specific requirements.

About the author

Prof Wynand Coetzer is an Extraordinary Professor at the Faculty of Electrical and Electronic Engineering at Stellenbosch University, as well as a business mentor for a number of small and medium-sized enterprises. He was a founding member of DataFusion in 1989, where he was technical director and the creative force behind the company. In 1998 he sold his shares in DataFusion to Spescom to pursue his own interests. He is the author of a book titled Engineering Entrepreneurship – Steering Start-Ups to Steady State.

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GET YOUR BUSINESS IDEA READY FOR TAKE-OFF



Sol Bezuidenhout

So you want to make it big like Branson did and be the next entrepreneur to go where no South African has gone before? The sky really is your limit, but before you launch off into the horizon on a pipe dream, you must do planning, otherwise you may burn out shortly after take-off.

Take a long hard look at yourself

Before you even jot down your idea on paper, you must face any skeletons lurking in your financial closet. Incurring debt to acquire assets that realise growth, such as buying a house, is usually regarded as 'healthy' debt, especially during periods of high growth in the property sector. Unfortunately we all fall into the pitfall of maxing out our credit cards to pay for our designer wardrobes, extracurricular habits and gadgets. If you have any 'unhealthy' debt, it may be a good idea to sort it out now. Otherwise you risk putting yourself in greater financial trouble if you run into hard times. This means developing a schedule (and sticking to it) for paying off your credit card, settling your Markhams/ Pringle account and putting that Ducati dream aside until you reach the big time.

Make your hard cash work for you

Now that you are free from your unhealthy consumer habits, consider saving some hard-earned cash. Investing in unit trusts, money market deposit accounts or fixed savings accounts are some reliable and simple options. This simple yet oh so smart move will allow you to accumulate extra capital needed to sustain you in the first few years of setting up shop.

There are mixed opinions about what's the best way to invest. Money market accounts have the advantage of giving you high interest rates, easy access to your cash and the ability to transact from your account (bank charges may be significant for transacting so make sure you read all the small print). Unit trusts are another option. Here your money is pooled with that of other investors and then invested in various assets (usually securities) by professional investment managers. The plus is that you can sell your units at any time and minimum investment amounts are low.

Over and above investing, if you are a homeowner you can take a second mortgage on your house or investigate government lending schemes. But be warned, taking out loans will only add to your accumulated paybacks further down the line.

Cash flow, cash flow, cash flow

So, you have covered the basics. You have rid yourself of most of that unhealthy debt and have some spare cash nicely tucked away in a five-year investment plan that delivers high interest results. Now it's time to put your A into G.

Of course your gem of an idea is itching to get off the ground, but take a deep breath and work out some smart strategies to ensure you have cash flow tightly under control. Alarming as the figure is, it is estimated that a staggering 90% of start-up businesses don't even make it off the ground. And the culprit is generally cash flow. Getting yours into rhythm isn't easy, but the extra slog upfront will charm you later on.

First, you need to look at your overheads and your spending habits. Is that cappuccino on the way back from the gym really that necessary? R16 every day can seriously add weight to a healthy cash flow. You also don't need fancy equipment – yet! Sure, boys need their toys, but you'll have to exercise some restraint in the early years.

Another area to look at is your cash cycle. We all want to be perceived as being a 'nice guy', but it shouldn't be to the detriment of your business. Customers have to realise that everything comes with a price. Negotiate early payment terms with customers and incentivise them to do so every month (discounts, loyalty programs, and so forth). Building a strong relationship with creditors, on the other hand, will assist in negotiating favourable payment terms. Managing this cycle efficiently will mean that you'll receive money every month before you have to fork it out. Even though it might be fairly expensive, factoring, which is considered to be off balance sheet financing, may be an option if you have a strong debtor's book. Make sure you understand ALL the OUTS before making any hasty decisions. It is, however, more attainable than traditional bank and equity financing and can help you with a steady flow of cash.

Playing with the big boys

Once you have put in the slog and your business is up and running and not at risk of going under in the near future, it is time to look at the next step: finance.

Surprisingly, banks are not your only financing option. You can look into government support and venture capital funding as alternative ways of raising capital for your business. But the rule of thumb before you ask for finance is to develop a professional business plan and conduct comprehensive research into your market, competitors and pricing.

Once this is checked, you need to carefully consider funding options suitable for your type of business.

Venture capital: Venture capital firms primarily provide capital (and expertise) to start-up and early stage companies in exchange for equity. This means that the money being invested into the business usually does not have to be repaid (as opposed to a loan). Venture capital firms often have specific mandates and usually invest in companies which have a proven revenue model, some customers, as well as significant potential for growth. Firms like HPVA provide expansion capital (funding) and also give continuous strategic support to the enterprise.

Angel investors: Angel investors are high net-worth individuals who invest their own hard-earned private wealth into businesses requiring capital for growth that may not be bankable as yet. In South Africa, the angel investor network is not well established, but you may have a great-grandfather who has earned his dues and needs a hobby.

Government funding: Government plays an active role in offering funding to start-up or early stage businesses. It offers finance in a variety of formats, such as grants, loans, rebates, tax incentives, co-investments or public venture capital.

These are some of the most well-known government initiatives:

- The Innovation Fund invests in young businesses and gives them a cash boost to get them up and running (www.innovationfund.ac.za).
- The Industrial Development Corporate (IDC) has set up a 2010! SWC BusinessFund that focuses on growing areas like telecommunications, media, domestic transport, FIFA headquarters, IT solutions and provision of infrastructure (www.idc.co.za).
- The National Empowerment Fund Trust (NEF) promotes economic equality and transformation and offers funding from a range of funds (www.nefcorp.co.za).
- The Support Programme for Industrial Innovation (SPII) promotes and assists technology development in South African industries (www.spii.co.za).
- The Umsobomvu Youth Fund (UYF) promotes entrepreneurship, job creation, skills development and skill transfer among young South Africans (www.uyf.org.za).

Banks: A trip to the bank is almost a rite of passage for entrepreneurs. Bank loans often become the only funding option for new companies, but they should be entered into with all the facts at hand. Remember, taking out another loan can place additional risk on your business, and usually you will have to provide personal surety. On the other hand, it is often 'cheaper' (from a capital perspective) to lend money for the acquisition of things that generate revenue (like fixed assets), as you may rather want to use your hard-earned cash to fast track your company's growth by hiring a hot sales person. Debt can be a wonderful thing, but make sure you understand all the implications. Some of the commercial banks welcome options for loans for small businesses.

Who am I? Where am I going?

The final thought before launching your business is to establish which stage your business fits into.

- **Start-up:** You are a very young company. You either only have an idea for which you need funding to develop, or you have a product in existence, but no customers and funding is needed to take the product to market.
- **Early stage:** You have some existing customers, but profits are limited and you require funding to propel the company to a new level through development, marketing and growth.
- **Later stage:** You have been trading successfully for a period of time, have existing infrastructure, customers and products, but need funding for growth/expansion.

Tighten your seatbelts. It's time for lift off!

Good luck, enjoy the ride.

About the author

Sol Bezuidenhout is the Investment Manager at Hasso Plattner Ventures Africa, a venture capital firm which discovers and invests in some of South Africa's most promising ICT companies. He holds an M. Eng in Chemical Engineering from Stellenbosch University and a Diploma in Executive Management from the US Graduate School of Business. Sol gained experience in the Venture Capital Industry as an Investment Analyst at Mark Shuttleworth's HBD Venture Capital where he also represented HBD as a director on several of the boards of their portfolio companies.

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NEGOTIATING AND DRAFTING SHAREHOLDERS' AGREEMENTS



Derick Swart

1. Introduction

Shareholders' agreements govern the relationship between shareholders in a company and as such are probably amongst the most important contractual documents that shareholders will ever enter into. This short article aims to set out some of the practical considerations to be taken into account when negotiating and drafting shareholders' agreements.

Shareholders' agreements are often rushed to completion, only to be dusted off many years later by legal practitioners who scrutinise them in an effort to ascertain the true meaning of the parties. While this article does not provide a comprehensive discussion of the topic, it is submitted that the risk of this happening can be minimised if the parties have regard to the pointers set out in this article. More than often the agreements do not cover the disputes that present themselves.

2. Negotiation of a shareholders' agreement

2.1 Take the right stance

The successful negotiation of a shareholders' agreement requires a firm understanding of the desired objectives to be achieved and the terms which are required to achieve those objectives. This is particularly relevant when the primary reason for forming a company is to establish a vehicle for the commercial exploitation of intellectual property.

Having 'best case' and 'worst case' scenarios formulated ahead of time, along with a clear understanding of one's mandate and bargaining position, will focus negotiations on commercially realistic proposals.

Although it is not always possible, a healthy bargaining position must include the possibility of declining to proceed with the proposed transaction if expectations cannot be accommodated. If the venture is started while the negotiations are still underway (which is often the case), the possibility of such a withdrawal without this entailing negative consequences, which may include legal action, becomes more remote.

2.2 Get the right people around the table

If possible, one should insist that the parties to participate in the negotiations must have a firm mandate to negotiate. When this is not the case, for instance where subsequent board approval is required, this fact should be noted at the start of negotiations. Too often negotiators find themselves in a corner and use the convenient tactic of pleading a limited mandate.

Decide upfront on whether to include a legal practitioner to assist in the negotiating process. Introducing new parties or personalities later in the process of negotiation may change the dynamics and could necessitate the renegotiation of key points, which could in turn lead to a breakdown of the negotiating process.

3. Drafting a shareholders' agreement

3.1 Start with a 'deal sheet'

Before drafting the shareholders' agreement, the parties should ideally agree upon what has become known as a 'deal sheet'. This is a short, bullet point document that outlines the salient points of the envisaged shareholders' agreement.

Since the shareholders' agreement will embody the terms agreed in the deal sheet, the risk of material issues derailing negotiations later in the process is limited.

3.2 Be clear and definite

Be sure to state the specific purpose of the company and the mandate of the directors. Expressly state how pre-existing and new intellectual property rights will be dealt with. Be sure to clearly state the intention of the parties regarding where new rights will vest, and when such rights will vest. Where registered intellectual property rights are involved, stipulate clearly who will be responsible for the maintenance thereof, and how the associated costs will be dealt with.

3.3 Be careful with 'sweat equity'

It is not uncommon for shareholders to start a company on the basis that one of the parties will pay for its shares in the company by rendering certain services. This is known as 'sweat equity'. The parties are typically excited to get the venture underway and neglect to state precisely in their agreement the scope, milestones, timelines and performance criteria for the services to be rendered.

'Sweat equity' arrangements are often encountered in the context of software enterprises, where a software house or developer may become involved in a company on the basis that it is to earn its shareholding by undertaking the development of certain software.

Such situations should be handled with no less attention to the deliverables than would have applied had the software company been retained on an arms-length basis as an external consultant or contractor.

3.4 Funding

Parties often use standard form shareholders' agreements which have unintended consequences when it comes to the funding of companies. The funding provisions should be carefully considered, since they could hide suretyships, obligations to make available funding at the discretion of the directors and coupled to that, draconian share dilution provisions should a shareholder not be able to comply. The funding provisions should be tested against a realistic cash flow budget of the proposed venture.

3.5 *Exit plan*

Consider and agree upon an exit plan should the venture not succeed. Where the agreement envisages the exclusive right to commercially exploit certain intellectual property, care must be taken to ensure that sufficient checks and balances have been provided to prevent the intellectual property from being tied up indefinitely in a dysfunctional entity.

3.6 *Get it signed!*

More than often, operational issues of a new venture dominate structural issues (paper work) with the result that the shareholders' agreement is not signed. An unsigned agreement complicates the enforcement of rights and places a heavier burden of proof on a party that has to fall back on the agreement to enforce its rights.

4. Amendments to the Companies Act

Readers may be aware that a new Companies Act has been signed into law. This act is called the Companies Act, 2008 (Act No. 71 of 2008). Although it is expected that the new act will not come into force until around July 2010, it is noteworthy to consider some of this act's implications. Although a detailed review of the act falls outside the scope of this article, there are a couple of key points to understand and consider.

Where a company's authorised scope of business was previously limited to that stated in its public documents of incorporation, this will no longer be the case. Shareholders accordingly need to be specific about the mandate of directors and other officers of the company.

Previously, shareholders' agreements contained a standard clause that simply stated that, to the extent that the memorandum of association and articles of association were in conflict with the shareholders' agreement, the latter would prevail and the parties would do what was necessary to make it so. Under the new act, the memorandum of association of the company will supersede the shareholders' agreement, in other words, the shareholders' agreement may not be in conflict with the memorandum of incorporation.

As an aside, close corporations will continue to exist under the new act, although it will be impossible to incorporate new close corporations after the new act comes into effect.

5. Conclusion

The considerations discussed will hopefully provide some pointers to negotiators and drafters of shareholders' agreements. The comments are not intended to be comprehensive as shareholders' agreements are complex transactions. The terms of each prepared agreement must be carefully considered against the specific facts of any proposed company structure and initiative.

About the author

Derick Swart is Director: Intellectual Property and Technology Law at Cluver Markotter Incorporated. He studied at Stellenbosch University where he obtained BA (Law) and LLB degrees. His experience includes lecturing Private Law at Stellenbosch University and he is the author of a chapter on online payment systems in South Africa's first book on Internet law.

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CORPORATE GOVERNANCE AND START-UPS



Brett Commaile

Jimmy and Pete were talking over a few beers on a Friday night. Jimmy was on his fifth beer and had plans for plenty more. It had not been a good day. He was in the process of selling part of his business to an investor. He didn't like the admin that followed, but he needed the investment to boost the business to the heights he had been dreaming of.

Ever since he started in business, he'd been a 'one-man show'. He got stuff done, made payments, processed documents and did whatever he had to do to keep growing his business. He had no formal procedures he just made sure that things happened before somebody called to complain that they hadn't happened yet. As his business grew, he hired more staff and they took over the mundane activities he hated, like accounting and banking, ordering stock and collecting payments. He hired people who he felt he could trust to take care of the tedious jobs while he got back to selling his products and meeting clients.

On that particular day, as the investor's due diligence drew to a close, he sat down with the auditors. He felt a glimmer of optimism, like a Stormer's supporter at the start of the Super 14 season. Unfortunately, just like his favourite team, his optimism was soon to be crushed. In doing the due diligence, the auditors had found several suppliers with balances outstanding for several months. The amounts were huge; however, the

books showed they were paid. When they asked the accountant for an explanation, she took a toilet break and disappeared. Jimmy had been robbed. His most diligent worker, aided by another star performer, had gradually stolen a fortune. The business was actually in debt over its head.

Two months, and far too many beers later, two of his suppliers were also out of business due to the bad debt suffered from Jimmy's business. Although he didn't realise it, the collapse of Jimmy's 'one-man show' had ultimately led to more than 14 people losing their jobs while many more surrounding them felt the knock-on effects.

But this is not a story about fraud. The bad guy could have been a giant electrical wholesaler who opened up next to Jimmy's and put him out of business. It could have been Jimmy himself who drew too much money from the business until it collapsed. What it does illustrate, however, is two important things, namely:

- the importance of appropriate corporate governance and all the controls that should be in place to prevent such situations; and
- the far-reaching effects of failing to consider or implement them.

Many entrepreneurs will face these failures, some of them several times over. We don't hear about the small ones as they are simply too common, but we are all familiar with their bigger cousins, such as Enron, Fidentia and the recent ponzee scheme involving Mr Madoff, to name a few.

We've all heard loads about corporate governance and experience it, or the lack thereof, on a regular basis. You can find several formal definitions that sound accurate, but don't feel very tangible or easy to implement. Let's look at those that make more sense to me.

First, there's Sir Adrian Cadbury who is quoted in many of the corporate governance guidelines around the world. He effectively said the aim of corporate governance is to align, as nearly as possible, the interest of individuals, corporations and society. In other words, to do what is right, proper, honest and decent, and balance the goals of individuals and the community. It gives a nice standard to measure one's actions against. It acknowledges that the stakeholders in a business – those who are affected by its failure or success – include a group far larger than the owner or shareholders. They include creditors and suppliers, debtors and customers, staff, investors, government, the community

and the environment. (In Jimmy's case it also included the local pub owner who let Jimmy get a bit carried away in drowning his sorrows, all on an impressive line of credit.)

It is for their sakes that men and women in suits slave away in rooms without sunlight to produce the King Report on Corporate Governance. The latest revision of the report is King III, and it's out in draft for public debate. Most importantly, while it used to be compulsory for JSE listed companies, it will now be compulsory for all companies, big or small, listed or not. I'll leave the explanation of King III to those folks who wear black robes and grey wigs during office hours. It is the subject of much debate, which I will avoid here. Suffice to say you cannot ignore it.

I spoke to the Head of Risk for a listed group who said that for him, good corporate governance is not falling victim to the three corporate sins: sloth, greed and fear:

- Sloth is bogging down the passionate entrepreneur in so much admin that he loses all his fire for the business, thus causing the business to stagnate.
- Greed is not maintaining the right division between personal and business affairs.
- Fear is when one over-regulates with too many checklists and procedures so that one becomes afraid to act. We have all encountered individuals who will not make a decision for fear of being held responsible.

The challenge is to find the balance and in essence it comes down to how much risk you are willing to accept. It's a lot like safety clothing. In cricket, if you were to put a batsman in sufficient protective clothing to prevent a ball from ever touching him, chances are he would not be able to move at all. Instead you protect the sensitive areas, those where a hit could be crippling and have disastrous consequences. You do this in a manner that still allows freedom of movement. There is still a risk of being hit, but the damage should be minimal; far less than if he walked out with only his uniform and a bat. So too with your business; ensure solid controls in the sensitive areas that need it most, but be sure you don't restrict the business' ability to operate effectively.

Long before Mr King's reports became the corporate standard, Dr Anton Rupert drew up the following guidelines for doing business successfully:

- **Honesty** – because it lasts the longest.
- **Correctness** – because it creates trust with friends and opponents.
- **Courtesy** – which means dignity without pride and friendliness without subservience.
- **Service** – in every respect: to your client, your fellow man, your country.
- **Mutual support** – so that you push others up the ladder of success while climbing yourself, because if you pull others down, you will also fall.
- **Trust** – the belief that all will work out well if everyone is doing their duty.

If you can implement these principles in your fledgling company and ensure they are pervasive, your corporate governance is off to a flying start. You now have several overarching values within which to set up your framework. Your ethics will determine how rigorously you apply them.

We could leave it within this framework, but I want to briefly touch on some of the detail we encounter daily working with start-up businesses. In general, these ventures are not yet businesses. They are often still just a product and a plan – the businesses and the companies have yet to be built. The entrepreneur is focused on his or her product and has often not paid too much attention to matters of corporate governance. There are exceptions. They usually take the form of experienced businessmen setting off with a few like-minded individuals, who have a list of directors and roles, often longer than the product description.

As a supplier of venture capital, our objective is to guide a company to install a level of corporate governance that is appropriate for the company. We do this for a few reasons:

- Protection of investment – we need to make sure that the money we put in goes where it should.
- Protection of people – employees and principals need a framework within which they are safe to make decisions.
- Protection of sustainability – the business needs policies and procedures that protect the assets and best interests of the company (and its stakeholders) from both current and future threats.

- Very importantly, we want the business to be attractive to future investors. Investors value a business which is well structured, with clear responsibilities, checks and balances.

So we come back to risk management. It is critical to understand the various areas of risk that can affect your business. Start with the broader risks, such as changes in the economy and political environment or legislation. Consider market risks and competitive forces and products and how you will approach them to ensure the longevity of your business. Finally, don't ignore internal risks, such as fraud and theft. Once you have clearly identified them, you need to plan how to deal with them, be it proactively or reactively. It's a tough task, but can be a real eye-opener that could save your business.

As mentioned previously, the last thing you want to do is burden a small company with unnecessary admin, so make sure you get value from the process. An example would be the board of directors. Even small companies require them. So instead of picking old buddies to be your non-exec directors, find people who can add experience and wisdom to the operations, as well as bring a network of contacts you could access your business. There are many people who are passionate about entrepreneurship and some scouting around should deliver many worthwhile candidates. Importantly, the board will also advise you on the various areas of control.

It is challenging at first to involve outsiders in your business, especially if you are used to calling the shots. The goal, though, is to get a mandate from the board that allows sufficient freedom, but ensures you keep them informed and get their buy-in when you need it. If you have funders, they will generally also require a seat on the board. Ask ahead of time, though, what role they plan to play. Make sure it is not just to arrive every three months at the meeting and look at the accounts. Draw on their experience; leverage their network to benefit your business. Getting this right can be a significant boost to your business.

Next is one of the toughest things to get right in a small business: internal controls and segregation of duties. Get it wrong, though, and you end up like Jimmy. Avoid treating your small business like your wallet – opening the register when you need cash without keeping track – and run it as a separate entity, with a few standard critical procedures performed by assigned individuals. Put controls in place over key activities like bank reconciliations, and review these in minute detail. You can get everything else right, but failing here can destroy your entire dream.

Talking of cash, we should touch on cash flow and the importance of managing it well. A common mistake in a new company is to watch the sales skyrocket and before you know it, you run out of cash because it was all tied up in stock and debtors. It's called overtrading and seems like such a silly way to go out of business, but the consequences are just as devastating. Plan your cash requirements for the month and year ahead and know what you need to do and what your limitations are to ensure you do not run out of funds. Not doing a cash flow forecast is like driving your car at night without headlights; it becomes very likely that large obstacles will appear ahead and stop you in your tracks. The forecasts, like headlights, are more than just a good idea - they are essential.

Having touched on a few basics, we come back to risk management. You have a fantastic product and you know there are many customers just waiting for it. What is there inside or outside the business that could prevent it from happening, or even just slow it unnecessarily? Good corporate governance includes having the systems in place to identify risks and to deal with them in a way that provides reassurance to the stakeholders that everything is going to be just fine.

Just as you work to instil good habits into your children from when they are young, so should you do with your small business. Cultivate habits in your young company that are an extension of your values and ethics. They will stay with the company as it grows and will serve as a strong foundation for a framework of corporate governance, and for a respectable, sustainable business.

About the author

Brett Commaille is the Chief Executive Officer of InVenFin, an early stage *venture capital fund*. He completed his *B Com. (Accountancy) Hons* at The University of Pretoria and subsequently qualified as a Chartered Accountant, working at *Deloitte and Touche and PriceWaterhouseCoopers* in the Middle East. He returned to South Africa where he spent five years working in *Standard Bank's Corporate and Investment Banking division* before jumping at the opportunity to join InVenFin. He currently works at InVenFin's Stellenbosch Offices and is always on the lookout for the next *grand innovation*.

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RESEARCH AND DEVELOPMENT OF THERAPEUTIC AND MEDICAL DEVICES



Pieter Fourie

1. Introduction

The research and development of any medical or pharmaceutical product are significantly more sophisticated due to the intricate and unfathomable myriad of regulatory issues guarding the final introduction of the product into the market. Furthermore, the recent upsurge in litigation, related to product failure or side effects or adverse events, has increased the cost and complexity of clinical trials to the point where it has moved outside the financial capacity and technical know-how of the small entrepreneur.

2. Initial concept evaluation

It is important that the innovative concept goes through an initial concept evaluation that includes the following:

- Design analysis;
- Initial market analysis;
- Evaluation of intellectual property;
- Manufacturing issues;
- Cost analysis.

3. Initial market analysis

In order to ascertain whether a new concept is viable, it is essential to determine its market acceptability. FDA regulatory guidelines stipulate that no new medical product will enter the market unless its consumer acceptability has been demonstrated.

4. Intellectual property

Any new concept is deemed patentable if it is considered to be novel and innovative. Although it is not essential, a patent search could help to establish its novelty and whether any prior art exists that could affect the final patent acceptance.

5. Regulatory issues

The product must conform to international standards of quality, safety and performance. ISO standards for the research, development and production are well established for medical and pharmaceutical products and are a prerequisite for CE mark and FDA approval. No medical product will be accepted for sale in South Africa without either a CE mark or FDA approval.

6. Prototype development

ISO standards specify the protocol for the development of the initial prototype with specific guidelines in terms of biocompatibility of materials, biohazards (for example, isotope radiation) and electrical safety.

7. Clinical trials

All medical products must be evaluated clinically. Phase 1 clinical trials are set up to evaluate 'proof of concept'. The efficacy of the medical device is determined during phase 2. Phase 3 concentrates more on adverse effects and long-term benefits. An institutional ethical board must approve all clinical trials.

8. Pre-production prototype

A pre-production prototype must meet all the requirements as set out in the ISO, CE mark and FDA guidelines and conform to the clinical trial specifications. Labeling, as well as the primary, secondary

and tertiary packaging, must meet requirements such as sterility, biohazard and radiation standards.

9. Production

It is essential that the production facility and methods follow the same stringent FDA, CE mark and ISO guidelines.

10. Marketing

Marketing of medical products must include training of personnel on all levels, as well as that of medical representatives, nursing staff, doctors and technicians. Post-marketing surveillance is essential to guarantee the safety of the device and the report of adverse events.

About the author

Prof Pieter Fourie is an extraordinary associate professor in Anaesthesiology and Critical Care at the Faculty of Health Sciences at Stellenbosch University. After obtaining a B.Eng (Electrical Engineering) and working on computer-aided design of Gunn oscillators, Pieter obtained a degree in medicine followed by a PhD in Medical Physiology. He subsequently trained as a specialist in paediatric medicine, and was appointed as an associate professor in Medical Physiology. He has acted as Director for the Bureau of Bioengineering (Stellenbosch University) and Director for both Harwill Medical and Mushroom Biomedical Systems.

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NURTURING PARTNER RELATIONSHIPS

*Some insights from
IDC's Venture
Capital Unit*



Harshik Gopal

The very basis of interaction between an investor and an entrepreneur is their mutual relationship. The fact that an investor has invested in a company implies that while the product, market and other aspects of the business proposal are attractive, there is a fundamental trust between the two parties which will govern their future relationship. It is this mutual trust that forms the very foundation of a fruitful and long-standing association between parties. Damage done by the breakdown of trust is incalculable.

IDC's Venture Capital Strategic Business Unit (VC SBU) was established about two years ago to address a need in the market for funding the seed to early start-up stages of technology-based businesses. The VC SBU invests between R1 million and R30 million in equity for a 26-49% shareholding in the company. Drawing from the 70 years since establishment of the IDC and the more recent experiences of the VC SBU, the most important factors in partnering with entrepreneurs are mutual trust, openness and respect, and the personal relationship of the IDC's account manager (AM) with the client thereafter. The AM attends monthly management meetings and acts as an advisor and sounding board with contributions made mainly in the financial

area. The CEO of the company, having the knowledge of the business and its market, actively runs the company. For objectivity and good governance practice, an IDC-appointed director sits on the company's Board of Directors and is independent of the VC SBU.

Pre-investment deal-structuring is seen as the most important tool for determining post-investment behaviour. It is used as a disciplining as well as an incentivising tool. Venture capitalists can choose a 'hands-on' style of investor involvement in the investee. This can be seen as intrusive/counter-productive. This is because involvement can be expensive in terms of investor management resources and may be against the investor's policy. However, a totally 'hands-off' management style can also be detrimental to the company. The investment decision will take into account whether the company is 'ready' for investment. This may not necessarily mean that all operational matters are in place, but rather that the company can move forward with some assistance. The style of managing investments therefore has to be determined on a case-to-case basis with factors, such as the following, to be considered:

- The relevant experience and track record of the entrepreneur;
- The composition and profile of the management team are all key positions filled?;
- The business development stage of the company;
- The company's financial control systems;
- The product readiness and marketing strategy implementation processes;
- The landscape of the industry and market that the product is aimed at;
- The investor's business network and industry knowledge and leverage;
- The company's negotiating power.

The business environment constantly evolves and continually alters the challenges companies face. Communication and information flow from the company's CEO allows an investor to keep abreast of these developments in the macro-environment, as well as the steps the company will take to adapt to these changes. The CEO needs to foresee how these movements will impact on the company's strategy and financial resources and must alert investors of pending

challenges. Information flow to investors must be a balance between formal (timeous management accounts, other reports agreed upon, management meetings, etc.) and informal discussions between the AM and the company management.

Usually, delays in receiving the company's management accounts and reports, as well as breach of board covenants, signal possible distress to investors. To stand the best chance of co-operation from investors, companies need to communicate to investors at the first signs of a crisis, and not at the point of looming disaster. The investor should be recognised as a partner with vested interest in seeing the company succeed. The investor will then not only be able to lend objective guidance and assistance through resources at its disposal, but will also be ready to prepare for further funding or restructuring if the situation warrants it.

A healthy investor/investee relationship forms the cornerstone of business with the relationship extending far beyond the start-up stage. Familiarity with the entrepreneur's style, skills and competence form the platform for future business endeavours. Apart from the financial benefits derived from a partnership, the relationship built may prove to be of greater value.

About the author

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EXIT

*When?
How?
How Much?*



Martin Wright

For an entrepreneur the possibility of exiting a company which he or she has developed, can often be one of the most difficult and stressful stages in the life cycle of a company. However, it can also be one of the most rewarding; both from a financial and from a self-fulfilment perspective.

The first issue many entrepreneurs need to come to grips with is to try to decide on the right time to exit an opportunity. There are a number of factors that should be analysed to determine this.

Ability: There is often a time when the original management team no longer has the ability to maximise the future opportunity of a business. A person that is very good at starting a company and developing a product and evangelising its initial use is very rarely capable of managing the company as it grows and matures. Some entrepreneurs will hang on too long to a company - they are not prepared to exit and let someone else take over the reins and take the company to the next level. This is to the detriment of the company and often leads to its premature demise.

Personal desire: Entrepreneurs, by their nature, often generate new ideas. They have high energy during the formulation stages of a product and/or company, but rarely have the desire to stay with the company

and see it through to its maximum potential. They sometimes prefer to focus that energy on their next invention. When you feel your enthusiasm for your company diminishing or can't stop thinking about the next new thing, then it's time to exit and use the exit capital to pursue your next dream. Unfortunately, the original entrepreneur often exits too early or exits completely when a partial exit strategy may have been available. In this case, the company could go on to great heights and meet with great financial success – something the entrepreneur will no longer be a part of.

Opportunity: The reality is that exits are more often opportunistic than planned. Simply put, the best time to exit is usually when you have the opportunity to monetise what you think the company is worth. It's rare that this occurs at exactly the perfect time, so you should always seriously consider any opportunity to exit for a fair price.

How to exit a company you have successfully created is less complicated than you may think. Many entrepreneurs dream of creating a company that will be traded publicly on the stock exchange, a process we call the Initial Public Offering (IPO). However, very few companies go through the IPO process each year in South Africa. Most of these are extremely large companies that break away from existing public companies (such as the recent launch of Vodacom), or public companies resulting from the privatisation of a government entity, such as occurred with Telkom. If you are fortunate enough to be able to consider an IPO as an exit opportunity, you should have already built the company to a significant revenue size (generally in excess of R100 million per year) and it should have a track record of consistent growth with significant future prospects. You should also realise that in an IPO the entrepreneur rarely sells shares personally and that your opportunity to sell your shares often comes years later.

By far the most prevalent form of exit is in the form of a trade sale. By this we mean the purchase of your company by an existing, generally larger company or by some entity, such as a private equity investor or management team member who buys out most or all of the existing shareholders. It can be that the party purchasing you is a public company, in which case you may be offered either cash, equity or a combination of both for your shares. In this scenario you are usually freed of your overall management responsibility, but often have to stay with the company for six months or more in order to effectively

transition your responsibilities to the new owners. It's very rare that you're presented a cash opportunity without this kind of tie in, unless the value of the company is almost 100% in its intellectual property and with little or no value in its operations. This can be the case where you have invented something which can easily be licensed or manufactured by another company.

How much your company is worth, or as we call it in the trade, your valuation, is usually where people expect there to be a science. They, however, often find out the valuation is very subjective. Yes, there are models which can be applied to determine the current value of future earnings (the Discounted Cash Flow model), but as with this valuation model and all of the other models, the numbers you get out are only as good as the numbers you put in. It's easy to make a spreadsheet project that your company is going to be bigger than Microsoft in five years' time, but don't expect anyone to base their valuation on estimates like these. This really is an area where it's best to get competent advisors on your side. They will develop a number of valuation models and work on the average valuation of these models. They will also substantiate the underlying projections with real market research to potential buyers. And lastly they will negotiate the best deal on your behalf, both financially and based on your personal circumstances, such as how long you're prepared to stay with the buying company, whether you can travel or relocate, the payment terms you're willing to accept and whether there are any performance criteria.

About the author

Martin Wright is a partner at Cape Venture Partners (CVP), a company which provides advisory and management services to technology companies, entrepreneurs and early stage businesses. Prior to joining CVP, Martin was CEO of Emerald Solutions, a large IT services firm in the USA which specialises in developing large scale internet applications for Fortune 500 companies such as Nike, Intel, AT&T and others.

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