Thinking Like Your Investor

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Four General Areas of Advice

- How to understand the analysis method(s) your investor will use, and how to provide information effectively to close the deal
- When to be very specific to be in your use-of-funds statement (and when to give yourself more flexibility)
- How to handle questions about investor risk, and push for a better valuation without losing everything
- How to tweak your pitch when you need capital

Simple Math of High-Risk Ventures

- Consider an investor putting $1M into 10 ventures.
  - Seven lemons will fail outright – losing $100,000 each.
  - Two will go sideways – returning $100,000 (for simplicity)
  - One cherry will win – returning $100k + $900,000 profit.
- In any given group of 10 (seven of which are lemons), total amount returned is $1.2 million, for a 20% return.
  - If *one* lemon can be eliminated, total amount returned is still $1.2 million, but return is $300k/$900k=33%.
  - If *two* lemons can be eliminated (or *three* can be salvaged to go sideways) return is $400k/$800k=$500k/$1M=50%.
- Lesson 1: Investors try to <u>NOT</u> fund lemons at all.
- Lesson 2: Smart investors also try to salvage lemons.

The Goal of an Investor (or Fund)

- Generic portfolio goal: Turn $1 into $5 over 10 years.
  - If cherries return 10x, 1 cherry and 1 lemon will turn $200k into $1M – achieving the goal (if you can pick 50% winners)
  - If cherries return 20x, 1 cherry and 3 lemons will turn $400k into $2M – again achieving the goal (picking 25% winners)
  - If cherries return 40x, 1 cherry and 7 lemons will turn $800k into $4M – achieving the goal once more (at 12.5%.)
  - Notice the pattern: returns went up 4x, as did the *total* number of companies getting funded…but lemons rose 7x.
- What does this have to do with getting funded?
  - Lesson 3: Don't be a lemon in the first place.
  - Lesson 4: Try not to look like an *obvious* lemon.
  - Lesson 5: If you're *not* a lemon, PROVE IT.

The Fruits of Due Diligence

- Everyone thinks VCs find (and fund) cherries.
  - They don't. They identify lemons.
  - Nobody ever hired an employee based on what was found in a background check – but some decide NOT to hire.
- Every investor ever: "How do I find cherries?"
  - Every business plan ever: "Look at me! I'm a cherry!"
  - Every b-plan reader ever: "Yeah, riiiight. Sure you are."
  - Every lemon ever: "How can I find someone who won't do their homework -- and thus who will invest money in me?"
    - This is called "pooling" and is achieved via *silence*.
  - Every cherry ever: "@#$%^& lemons! Making it hard to raise money! How can I look different from a lemon, in a way that's obvious to everyone?"
    - This is called "stable separation" and achieved via *signals*.

Being Specific on Use of Funds

- THE WRONG WAY: “U can haz 10% of our biznis for $400k.”
- The right way:
  - Your business needs capital to grow. You’re going to use this money to push the business forward (I hope!) and not simply put it in your pocket.
  - As the founder, you have a very good idea of *how much* you’ll need, *when* it will be spent, and *on what* to achieve *which goal*.
- YOU SHOULD SAY THESE IN YOUR PITCH, OR AT LEAST KNOW THE ANSWERS TO QUESTIONS ABOUT THEM.
- Think of it as an ATM: AMOUNT + TIMEFRAME + MILESTONE
  - “As you can see from this table, we need $250k to get us to market, which will be spent on design and prototyping over the next 12 months.”
- Your goal: At the end of the meeting, to have investors saying
  - “I want to work with *this* entrepreneur” and
  - “I want to get my money in, *early,* into *this* venture.”
  - If they’re thinking this way, they *will* come back with a term sheet.

Talking the Investor into Funding You

- Show how much capital is *actually at risk*
  - "Qualify" investments for the lower rate, as in a debt/equity tranche
- Emphasize The Risk-Reward Tradeoff
  - Return on at-risk capital K is the relevant measure, not ROI on $K+K_0$.
- Explain how initial investment carries options
  - *Raising* or *doubling down* -- Put in more money when clearly "ahead"
- Set milestones after which capital will be returned if these milestones are *not* met (a la Discovery Driven Planning)
- Show your investor that *you* (the entrepreneur) want to "squash a lemon" even earlier than she does
  - For small investments (e.g., less than $1M), your opportunity cost of time is *much* more than her opportunity cost of capital (do the math)
- Show you've thought out the competitive analysis

Talking the Investor into a Good "Pre"

Premoney Valuation: Implied business value *before* $ goes in

- Emphasize The Risk-Reward Tradeoff ***ratio*** on *K*
  - Higher multiples on a smaller capital base (with a decent probability)
- Sweeten the value of the Angel's raise/double-down options
  - These only matter if you get amazing Pre's in Round A/B
- Stress that you *can* raise not-at-risk capital elsewhere – but at a higher cost, which comes out of at-risk capital's profits
- Offer *dilution* protection and *tag-along* options
  - Later investors won't wash out early ones
  - right to invest/convert if better terms offered
- Explain that incentives are important
  - Give management (other than you) options to motivate them
  - Leave room for A round investors at the $3M+ level
- Don't take a (cash) founder's salary above about $3-4K/month
- Charge *a lot* more for a controlling interest in the firm

Final Thoughts: Raising Much-Needed Money Without Giving Away The Store

- Problem:
  – Every startup eventually needs a small amount of money, urgently, to get something done – whether to avoid a big problem or to seize a great opportunity.
  – Many entrepreneurs miss these opportunities because they insist on raising more than they need, or won't agree to investors' terms.
- Solution:
  – Signal to your existing investors (using the ATM method) that you have a one-time, specific need for a particular amount of capital, and that you are open to creative offers.
  – While you're waiting, figure out how you would solve this problem in your dream world…then realize that you're not living there.
  – Get an offer from your investor with worse terms than what you wish you could do, but substantially better than passing up the opportunity.
  – The *difference* (between what you'd pay in an ideal world vs. what you're being offered) is your cost of getting out of your jam (or of seizing the opportunity.) Think of it in dollar terms, not percent or shares.
  – Shrug and say "In the grand scheme of things, that's OK."
  – Seize the opportunity and don't look back.