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| Stage | Needs to raise money | |

THE THREE R'S FOR INVESTORS

File No. 3.020306 | 2017-06-01

Quick Summary: Establishing a mutually satisfactory relationship between the company and their investors is critical.

Abstract:

Discussions about risk and reward take center stage in any investor discussions. Risk and Reward represent two of three R's for investors. However, neither is important if the bi-directional relationship between the company and the investor is not first built on trust. The Relationship represents the third and most important R.

For years, we have heard about the three R's in education: Reading, Riting, and Rithmetic. Obviously, spelling didn't make it to the list! For investors, there are also three R's: Risk, Reward, and Relationships. Many articles, including a number in this series, are written about the need to balance risk and reward. However, few articles are written about the most important R: Relationship.

There is no question that an entrepreneur is focused on selling the opportunity to invest in their company to potential investors. And there is no question that financial investors are very cautious prospects. History supports the investors' skepticism. The numbers speak for themselves. Only a very small percentage of entrepreneurs ever attract investment capital. And of those that do, approximately 90% of the returns come from 10% of the companies. Clearly, investors do not invest to lose money. Every investment is made with the belief that the opportunity will be one of the ten percenters that provides a substantial return.

Entrepreneurs clearly have their work cut out for themselves; selling their vision and the associated opportunity. To be sure, investors will listen carefully but will pursue independent validation. "Trust but verify" is the standard approach. Even with thorough due diligence, an investor cannot cover every conceivable issue. They must rely on some of the company's data and expertise. If the relationship proceeds to the point of actual term sheet negotiations, investors will naturally attempt to develop the most favorable terms they can. Many investors do this for a living, and they and their colleagues are experts in the "art of the term sheet" and deals. Even with experienced attorneys helping entrepreneurs, mutual trust must exist for establishing a fair and equitable long-term relationship. Mutual success, not assured mutual self-destruction must be the goal.

The beginning of the relationship starts with the entrepreneur. They are expected to be committed and bullish about their opportunity and always see the glass as half full. Investors will start out skeptical and

defensive. A highly successful founder and managing partner of a venture capital firm once explained his cockroach theory: "If you see one cockroach on the floor you can bet that there are thousands in the walls!" So, suppose an investor sees one obvious error or misstatement in an entrepreneur's presentation. In that case, the investor can be fairly confident that there will be others that may not be so obvious. If trust is broken or even damaged in the beginning of a relationship, it will be hard to recover IF there is even another opportunity.

Similarly, if an investor takes unfair advantage of a company during the investment negotiation phase, the company, probably in desperate need of the money, may accept the deceit and "forgive" but will probably never forget.

The solution is simple. Both parties need to work hard to build trust into their relationships and make trust the key investment made to each other. Both have to always think about their ongoing relationship after the fundraising dance is long over and life together begins.