

Inside the Head of Investors Presentation Notes

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The following is a copy of the text that is included in the Notes section of the PowerPoint™ slide deck referenced above. These notes are intended to provide talking points and background information for each slide. This document is most useful when reviewed while simultaneously looking at each slide in order to understand its context.

Slide 1: Inside the Head of Investors

This presentation discusses a variety of topics centered on seeking funding from Angel and Venture Capital professional investors. It follows the presentation, “Funding Alternatives” that lists several different funding sources. That presentation, as well as this one, presents a realistic, if not somewhat negative, view on the likelihood of an entrepreneur securing a capital investment from either of these groups.

It is natural for an entrepreneur to think of their opportunity as being a standout investment, which is “almost sure” to be a huge success. Unfortunately, all entrepreneurs feel the same way but only a small fraction ever provides the investment returns that financial investors desire.

One of the keys to success in pursuing financial investors is to focus on what they want to hear and not what the entrepreneur wants to say! There is a significant difference between these two points of view. This presentation is intended to help an entrepreneur understand those differences.

Slide 2: Investors Categories

This slide is a copy of the slide used in the “Funding Alternatives” presentation. It is intended to level set the focus of this presentation. The key characteristic of the Angel and Venture investors is that they are focused on investing in your business and not your well-being. They will, of course, want to have confidence in your ability to prudently manage their money and guide the company along its journey. Make no mistake, that their loyalty will be to the company and maximizing their return. Hopefully, you, the entrepreneur, will remain an integral part of that journey. Compare that attitude with Friends and Family investors who are investing in you.

Note that the Private Equity category is partially highlighted on the slide. As will be discussed later, the Private Equity category is not a viable funding source for a startup (and neither is an Initial Public Offering).

Slide 3: Rough Investment Ranges

This slide is also a copy from the “Funding Alternatives” presentation. It is provided as a reference. Note that this slide, like many others in this presentation, make general statements. In all cases, there will be exceptions. Venture firms, for example, in later rounds may make significantly larger investments than the \$10M shown on the slide. Similarly, very few venture firms will make investments as low as the \$1M shown. In those cases, SAFE or Convertible Note investment vehicles described later in the presentation will probably be used.

Slide 4: Things You Need to Know*

The asterisk comment on the title is a reminder that many of the comments made in this presentation are generalizations that are directionally correct. Exceptions will exist. In fact, many Angel investors and VC firms take pride in showing how different they are from their peers. Some truly are. However, no matter how different they are in reality or on paper, they all share one thing in common: They invest to make money! That simple fact is why they are called financial investors. They are not called, for example, “company builders.”

Slide 5: Sun Tzu (500BC) and Today

If Sun Tzu were alive today and was talking to entrepreneurs and the startup community, he would probably have expanded his three war-time principles. Going one step farther, investors would want (demand) to know that entrepreneurs show a clear understanding of the first four statements shown. Entrepreneur responses to the four “knows” needs to be thoughtful and objective. This is not a time for handwaving and generalizations. Without sufficient responses, the entrepreneur’s funding battle will be lost.

Slide 6: What Do They Want?

Without a doubt, financial investors want to make money. It is just that simple. Amplifying that goal: They want to make lots of money, and they want to make it within the time frame that best meets their overall investment goals. The simple requirement of making money is exactly what investor’s limited partners expect them to do. Limited partners, such as pension funds, endowments, and institutions, have many alternative investment opportunities. Their goal is also to make money for those that have invested in them as well.

The biggest disconnect between entrepreneurs and investors is the direction of the money. Entrepreneurs are desperate to get money into their companies while investors are focused on getting their money out. Note that entrepreneurs are “desperate” while investors are “focused.”

Finally, investors would like a company to be successful; however, making money is far more important. This is not intended to be a negative statement or indicate that investors are insensitive. Instead, it is simply a reality of the situation. When things are proceeding well, this difference is not an issue. However, when the company is not performing well or if the investor is receiving pressure to show positive returns more quickly than what the entrepreneur feels is not in the best long-term interest of the company, friction can erupt. In most cases, investors win the argument.

Slide 7: Always Remember

Investors are presented with far more opportunities – often hundreds more opportunities – than they will invest in. Although investors feel some pressure to put their investment funds to work, their investment time frame can be measured in years. Entrepreneurs, on the other hand, typically need the money “now.” This situation makes negotiations lopsided. Entrepreneurs are at the mercy of the potential investors. This is especially true if the entrepreneur needs the investment for survival. Draconian terms from the investors are often accepted by the entrepreneur out of desperation.

Most entrepreneurs do not understand that investors always have control of the company, even if they only have a minority share of the stock and voting rights. By simply not supporting the company with their peers or with their “Rolodex” contacts, they can send a subtle message to the marketplace indicating that the company may be “soiled goods” that others should not consider. Of course, terms that shift control to the investors in the Operating Agreement can be more obvious and onerous.

Slide 8: The Angel Investors

Angel investors, acting alone or in groups, make investments in companies one at a time. Most of their investments are with local companies. They emphasize their relationship with the entrepreneur. They typically do not have the resources to do in-depth due diligence. Instead, they rely on references and the opinions of others. Angels are split: Some invest and then do not get involved with the company except for regular, mostly informal, updates. Others, typically individuals that have a thorough understanding of the company's technology or target market segment, may choose to become very active.

Angels may invest with simple vehicles such as SAFE documents or Convertible Notes and may not require an Operating Agreement. Other Angels, working together, may have very formal investment processes and documents. Often, a few Angels form a syndicate and will jointly decide to invest in a company through a separate LCC for the investment.

Angels are likely to invest in earlier stage companies than VCs, many have been burned in successive rounds led by VCs in which the Angels see their ownership and rights get "crushed" by new round terms. Therefore, Angels are likely to invest in companies that will require no or small future investment rounds.

Slide 9: Investor Characteristics

As discussed with the previous slide, Angel investors rely heavily on their personal interaction with the entrepreneur. They invest their own money as opposed to VCs who invest money given to them by Limited Partners. Therefore, Angels have a much more personal bond with the company and its success. VCs are focused on getting their money "out" of the company through a merger/acquisition or an IPO. Angels also want their money out, but some may be satisfied with a long-term, dividend-paying relationship. In general, Angel investors are more "patient" than VCs in terms of getting their money out of the company.

Slide 10: Venture Capital Firms

Venture Capital Firms are financial middlemen. They raise funds from organizations that have accumulated capital from their members. Those organizations include public and private pension/retirement funds, university endowment funds, family trusts, and other similar institutions. These institutions only invest a small portion of their overall capital in venture funds, hoping for superior returns but knowing that they represent a high risk. These organizations are referred to as Limited Partners. In that role, they do not actively participate in the VC firm's operations or decisions.

Although there are several variances, the general VC model is that a VC firm will raise an investment fund every four years or so. Fund sizes range from tens of millions to well over one billion dollars. Once raised, the VC firm's General Partners will invest in individual companies over the life of the fund. Most new investments occur within the first three years of the fund. Some portion of the overall fund is held back for add-on investment rounds for their existing portfolios.

During the life of a fund, often fifteen years or more, portfolio companies are sold, become public companies, or go out of business. Since new funds are raised every four years, VC firms are very interested in successful company exits within the first three years so that they can show their results to their existing and new limited partners as they raise their next fund.

As previously mentioned, the Limited Partners and the VC firms are focused on one thing: making money.

Slide 11: Investor Characteristics

VC firm General Partners and their Associates look at hundreds of investment opportunities each year. Their “look” may involve the casual review on an unsolicited email request from an entrepreneur or listening to a ten-minute pitch at local “pitch events.” At the other extreme, they may spend a considerable amount of time in comprehensive due diligence in advance of preparing a deal term sheet, which is the beginning of an investment negotiation.

A typical General Partner will make one, two, or three new investments per year. As a rule, between managing new investments and working with their previous investments plus looking at new opportunities, a General Partner can afford to be involved in only about ten companies at any one time.

From the outside, the life of a General Partner, with their “control” over company investments may seem glamorous. However, they spend long hours, need to juggle many balls in the air (company activities), and their successes and failures are clearly visible with successful investments being only a fraction of their failures. Pressure and long hours go hand-in-hand with their prestige.

Slide 12: Private Equity Firms

Private Equity firms follow the same model as Venture Capital firms with two significant differences. First, instead of investing in new, small, private companies which are the focus of VCs, they invest in well-established, large companies. The second difference is in the size of the investments that each group makes. VCs typically invest a few million dollars in a company in a funding round while PE firms invest hundreds of millions of dollars in a company at one time with the intent of acquiring all or at least the controlling interest in the company.

PE firms primarily invest in companies that they view as “distressed” or companies that seem to not be performing up to their assumed potential level. Unlike VCs that advise companies through Board of Director activities, PE firms “take over” operational control of the company, often replacing several key executives.

The goal of a PE firm is to significantly improve the financial performance of the acquired company and then sell it to another company or exit ownership through a new public offering.

Slide 13: Investor Perspectives

Similar to VC firms, PE firms typically will focus on a few market segments and develop the expertise to understand the market, the competitive landscape, and the core business model of potential investment opportunities. Most will have subject matter experts on their staffs that can “jump-in” and quickly address the issues that they believe can dramatically improve the company’s performance.

PE firms also understand that it may take several years for the company to make a dramatic enough “turn around” that either a suitor or the public markets will invest in the company.

Slide 14: Opposite Ends of the Spectrum

This slide highlights the same goal but dramatically different characteristics between Venture Capital and Private Equity firms. From this chart, it should be obvious that entrepreneurs and early-stage companies should not consider spending any time with PE firms.

Slide 15: VCs & PEs: What They Do

Although covered on other slides, this slide shows the process of Money-In and Money-Out for Limited Partners, Venture and PE firms, and entrepreneurs.

The success rates and financial returns for each group are discussed in subsequent slides.

Slide 16: The Real VC Numbers

There is a considerable amount of folklore that state the “facts” about financial returns. For Limited Partners, it is “common knowledge” that they get at least twice their money back by the end of the VC investment fund – which could take 15 years. The reality is that returns are closer to 1.2 to 1.4 times. An extensive report by the Kauffman Foundation several years ago reported some startling facts about LP returns supporting the 1.4, at best, return. Venture Capitals firms make most of their money from the annual management fees (~2%) that they charge the fund instead of on upside company outcomes. Also, surprisingly, the larger funds return less than the small funds.

VC firm giant success stories seem to get all the press and are talked about for years. The “unicorn” companies (private companies with valuations of over one billion dollars) are often held up as examples of how successful venture funding can be. However, the odds of a company reaching that status are probably very close to winning the lottery!

Slide 17: The VC Returns Model Myth

The last slide showed the common-belief venture success model, highlighted on this slide. The “logic” shows that for every ten investments, one is “home run” and returns ten times the venture firm’s investment. Unfortunately, this model does not provide the expected returns to firm’s Limited Partners.

Slide 18: Simple Returns Example

Calculating returns to Limited Partners is very complicated. VC investments in companies often involve using capital from multiple, overlapping funds. Terms can also vary considerably, and, in many cases, venture firm expenses are also charged in addition to the management fees. In the example shown, the VC firm charged a 2% management fee for the first five years of the fund and then only 1% for the next five years. In most cases, the declining rate of management fees is slower, so the VC firm makes more money. The model also assumes that some add-on investment rounds occur as shown.

For the case shown, the venture firm makes \$26.2M while the LP receives \$29.7M over their initial investment. Over ten years, this return represents only a 2.6% annualized return. The “10X” return from 10% of the companies following the “folklore” model is not sufficient.

Slide 19: Limited Partner Returns

This chart shows six different model scenarios. Note that to reach the 2X return on capital goal for a limited partner, the “home run” company needs to return almost 20 times the invested capital. Taking into account the assumed fact that the VCs retain 65% of the sales price of the company, the company has to be sold for almost 30 times the VC investment! An Excel™ model that can be used to create different scenarios is available on the www.CxO-Atlas.com website accessible through article 8.030201. It must be kept in mind that the model is very basic, and many other factors have not been considered. In general, those factors work to reduce the returns, not improve them.

Slide 20: What Does This Mean for Venture Firms?

The return numbers on the previous chart show that venture firms need a few giant successes to provide the required returns. Alternatively, they could reach the same level of success if more of their companies had better success rates than the “4 total loss, 5 breakeven, and 1 homerun” model. Rarely are more than one in ten companies successful to the degree required.

So, the venture firms, they must find an outlier – a company that returns at least 20 times their investment to begin to meet satisfactory limited partner return thresholds.

Slide 21: What Makes an Outlier?

With exceedingly rare exceptions, for a company to be an outlier, it needs to be purchased by buyers (other companies or the public market) that look well-beyond any of the standard valuation methods. For example, “X times revenue,” or “Y times profits,” or “Z% annual revenue growth,” rarely justify the company’s exit purchase price.

Often when a new “shining star” company fetches an incredibly high IPO valuation, there is a dramatic drop in its share price over the next few months. After the initial emotional hype wears off, rational investors begin to value the company based on sound business fundamentals.

Slide 22: Mythical Eight Steps to Entrepreneur

Not far behind the “5-4-1” venture success model is the mythical simple process to entrepreneur wealth and fame. “Pitch professionals” point to the, perhaps, 0.0001% of startups that successfully follow this model. The reality is quite different!

Slide 23: Perception Versus Reality

No entrepreneur starts a company planning for it to fail. Unfortunately, failure is the norm, while survival is the exception! Less than one-half of the companies that are started reach their fifth anniversary. By the tenth year, only 20% are left!

This is not limited to startups. It has been predicted that half of the S&P Fortune 500 companies will be replaced by 2027 – seven years from now. Although most of these companies will not go out of business, their relevance will significantly decrease.

Slide 24: Raising Money

The success rate in securing venture funding for a startup is astoundingly low! What makes this even more negative is the fact that it takes months and a considerable effort for the entrepreneur to go through this process. While they are immersed in this activity, they are not building their business!

You will never hear this statistic from the “pitch presentation” community!

Slide 25: The VC Funding Reality

The statistics shown in this chart should provide a dose of reality to entrepreneurs and help them carefully think through their funding strategies.

Combining two of the numbers: If the odds of receiving funding are 0.05% and of those funded, the odds of becoming a \$1B company are 1%, then the odds of startup reaching that status are 0.0005% -- buy a PowerBall ticket instead! It will save lots of time and anxiety and allow you to move on with the rest of your life!

Slide 26: Funding Odds

Taking another look at the funding odds, consider the dilemma for both the investor and the entrepreneur involved in the funding dance. Assuming an entrepreneur can somehow get the attention of a financial investor, they are fighting with hundreds of other equally motivated entrepreneurs that are also fighting for the same time and then capital from the investors.

Investors, with their time split on working with their existing portfolio companies, staying abreast of the market, and working on countless administrative tasks, must also find time to listen to visionary entrepreneurs. All the while, the investors know that despite their efforts, experience, and due diligence, only one of ten (at best) of their investments will pay off.

It's a tough game for everyone involved! To help increase the odds, entrepreneurs need to carefully understand who they are talking to and adjust their presentation accordingly. All of the potential audiences are predisposed to say "no" out of time survival.

Slide 27: Who They Are: Angels

Unlike VC General Partners, Angel investors invest their own money. In some cases, they co-invest with others in a quasi-family office framework. In general, they are willing to invest a small portion of their overall wealth in hopes of receiving superior returns vis-à-vis other investment opportunities. Without the structure associated with venture firms, their need for "superior returns" that are used to fund their operations and also provide returns to their limited partners, Angels can be satisfied with far lower return multiples with venture firms.

Venture firms with their contracts with their limited partners are expected to put the fund's capital to work within the first few years of the fund. Angels, on the other hand, do not operate under that time constraint and invest when the "right" opportunity appears.

Unfortunately, many Angels are referred to as providing "dumb money." This is an offensive label. If VCs, provide "smart money," why is their composite success rate less than ten percent? Also, if Angels are so "dumb," how did they accumulate their wealth? The term may more accurately apply to Angels that do not have any specific expertise that their companies have. So, in theory, they may not be able to provide applicable advice. On the other hand, most issues that companies face involve general business principles. The objective, unbiased views of these Angels can be valuable.

Slide 28: Who They Are

The Associates or Junior Partners in a venture firm are the workhorses. In most cases, they are the first filter or gatekeepers that often are first exposed to potential deals. Later in the investment review stage, they provide the detailed due diligence for their General Partners. They have great power in saying "no" to a deal but can only recommend to a General Partner who has the ultimate decision-making authority to say "yes."

Virtually all Associates vie for the coveted position of Partner or General Partner. They are, therefore, very competitive with one another. Also, they are far more afraid of making a recommendation to invest in a company that has a higher likelihood of failure than success. In general, they will pass on a deal rather than risk failure.

Attempting to bypass Associates is never a good idea.

Slide 29: Who They Are

Based on the size of the venture firm, it may have only a few General Partners and, perhaps, an equal number of Partners that are also empowered to make investment decisions. The process

varies from one firm to another, but, in general, it involves one General Partner, acting on their own and with help from their Associates, find a company that they believe is worthy of an investment. After identifying such a company, the General Partner will present it to their peer partners or a subset (Investment Committee) for consideration. In some cases, the larger group's consensus is required. In other cases, the larger group may simply provide opinions and recommendations for consideration with the final decision left up to the initiating partner.

Each firm will establish overall guidelines such as the number of new investments that a Partner can make in one year, the number of active companies that an investor can manage, or the investment amounts per investment.

Some General Partners are past entrepreneurs and, therefore, have a first-hand appreciation for what an entrepreneur, seeking capital, is going through. However, most General Partners do not have that experience. A common career path for them is to have graduated with a BS Degree and then go to work for a corporation. Some time later, they go back to school, usually a top school, and receive their MBA. They then begin working as an Associate within a venture firm and through long hours and constant exposure, they learn the trade. Few have ever held senior corporate positions, hired and fired people, and worried about making payroll or being crushed by a competitor. Their Board of Director's experience with their invested companies exposes them to a wide variety of issues. A variation of the line: "Not been there but seen that" seems appropriate.

Slide 30: Who They Are

The comments made on the last slide regarding General Partner experience may seem harsh but does reflect reality. Make no mistake, what a GP may lack in operational experience is offset by many other very positive attributes. Only the best and brightest ever reach General Partner status in this highly competitive field.

Entrepreneurs always must keep in mind two factors when dealing with everyone within a venture firm. First, their job is to make money, not great companies. If a company is highly successful, it is a bonus, but the primary goal is to provide superior returns to their limited partners. Second, each firm has many (dozens) of companies in their portfolio at any given time. The vast majority will not deliver the desired results. With the numbers involved, investors cannot feel as committed or passionate about each individual company as each entrepreneur/CEO does.

There is nothing "wrong" or "cold hearted" about these two factors; it is reality. Not surprising, it is hard for an entrepreneur to understand their point of view.

Slide 31: Who They Are

Many General Partners have or develop seemingly big egos. It is a natural occurrence due to the relationship that they have with entrepreneurs. In no small way, their decision to invest or not to invest in a company can determine a company's fate. Entrepreneurs come "hat-in-hand" first requesting an audience and then the opportunity to present their story. Many GPs remain positive and respectful of the entrepreneur's position and commitment while others do not. As usual, the "bad examples" seem to get all of the press! Unfortunately, there are crude, insulting investors as often exhibited by "Mr. Wonderful" on the television entertainment show "*Shark Tank*" that is heavily edited for consumer entertainment value.

Slide 32: What an Entrepreneur Needs To Do

Venture firms want one thing; to pick winners. They are inundated with company investment “opportunities.” As a matter of survival, they cannot independently verify a company’s business and potential and select the “winners.” It is up to the company to present their opportunity clearly and concisely to obtain and maintain an investor's interest. Companies must do this while dozens of other companies are attempting to do the exact same thing.

The most important factor for an entrepreneur to keep in mind is that while the entrepreneur is focused on getting money into the company, the investors are focused on projecting how and when they will get their money out – with a large multiple return.

Slide 33: “Companies are Bought not Sold*"

Although “quick-flips” do occur where a company, perhaps still in the pre-revenue stage, is sold for some staggering amount, these situations are rare. The norm is quite different. As previously said; “Overnight success often takes ten years!” Companies need to put together long-term plans and show a reasonable tactical plan to follow in order to maintain a potential investor’s interest.

On the other hand, early large spending plans based on projected future mega-success is a quick and total turnoff for investors. All companies plan to be successful, but investors know that few are. So, prudent spending until market acceptance is obtained is required.

Slide 34: What They Want

As previously mentioned, it is the entrepreneur’s job to provide sufficient information to an investor that will separate their opportunity from the dozens of other companies that have the same goal. A common mistake that entrepreneurs make is to focus on what they want to say instead of focusing on what investors want to hear; there is a huge difference.

Although most investors will specialize in a few market sectors, entrepreneurs cannot expect them to have a deep knowledge of their business. A common mistake that many entrepreneurs make is to assume that investors are familiar with many of the Three Letter Acronyms (TLAs) and Four Letter Acronyms (FLAs) used in the business. Investors may not be Subject Matter Experts (SMEs). Instead of asking for explanations, the investor, confused by the terminology, may decide to focus on another, less confusing business opportunity.

Slide 35: What They Want

With ten or so active companies in their portfolio and many other demands on their time, a General Partner can only spend a few hours per week with each company. When things are running smoothly, a few hours per week are sufficient. However, when companies are in trouble or, at the other extreme, raising more money or in the midst of merger or acquisition discussions, an inordinate amount of time is required. It is the company’s responsibility to provide concise and timely information – good and bad – to the investors.

Slide 36: What They Want

By now it should be obvious that General Partners and their subordinates cannot maintain detailed and intimate relationships with all of their portfolio companies continuously. An atmosphere of mutual trust and respect must exist. Investors do not want to run companies; they do not have the time and, generally, the expertise to do so. If investors and entrepreneurs/CEOs cannot develop and maintain a mutually acceptable relationship, there is one recourse, replace the CEO!

Slide 37: What Drives Financial Investors

When considering an investment in a company, investors focus on three major categories as listed. Knowing that most investments do not provide any or adequate returns, investors first focus on the risk associated with the investment. Risks can be internal, centered on the company's ability to execute its plans or external. There are a host of external risks, most of which are beyond the company's control, that can occur that can derail a company. Competition, perceived value, regulations, overall economic conditions are a few of the external factors that an investor will consider. A simple exercise consisting of envisioning the risks and then assigning the likelihood of their occurrence and the impact each could have can quantify the risks. Companies are advised to develop and share a risk analysis with potential investors to show that they have a clear understanding of their business environment.

As previously discussed, venture investments is a game of outliers. Investors are looking for companies that have the potential to provide superior returns. Clearly, for an outlier to occur, the "stars must align" with the company's offering, market demand, and a willing private or public buyer overly excited about taking advantage of the situation. Yes, there is a lot of luck involved!

Again, as previously mentioned, investors cannot run a company, they need to trust and rely on the senior management to do so. During the investment discussion stages, positive chemistry between the entrepreneur and their key staff members and the investors needs to develop. Often, this element is not adequately addressed.

Slide 38: Use of Funds Categories

This slide identifies seven different general company stage categories that are related to the use of funds that they are seeking from investors. Needless to say, as a company proceeds through these stages, the risk of failure decreases substantially. The last four categories all share one characteristic in common: The market has embraced the company's offering. In all four categories, the company does not necessarily "need" the investment. Instead, the investment will speed up growth.

Slide 39: Financial Investor Point of View

This slide, similar to the previous slide, shows the obvious inverse relationship between risk and reward as a function of the company's offering and business maturity. Unfortunately, many entrepreneurs do not fully appreciate this relationship and fall into the trap that if they had the money, they could quickly proceed through the maturity cycle. The reality is that once a venture firm says "no" it is very hard to convince them to reconsider later. Often, the firm will say "Come back later" but will seldom have time to listen later. Egos can play a big role in refusing to respond "later." If the company has made great progress, the new valuation will probably be significantly higher than the previous valuation. So, the investor may feel embarrassed that they "missed" taking advantage of the early "great deal" (that is obvious in hindsight.)

The magic word for getting investor's attention is traction. When customers actually begin to purchase the company's offering, AND the company can deliver it in scale to a large and growing market, investors will take notice. Anything short of the traction state requires a considerable amount of faith on behalf of the investors. Their thinking can be as simple as "Why take a chance with this company when there are so many other more mature opportunities?"

Slide 40: Investor Instruments

The old saying: "You set the price, I'll set the terms" is perfectly applicable to the company versus investor interaction. Aside from straightforward banking type debt instruments and the host of debt variations, there are three primary types of investment methods used by financial investors.

Within these three categories, dozens of term permutations exist. There is, however, one over-reaching principle that they all have in common; investors structure deals to give themselves the biggest benefit that they can obtain. Again, remember investors invest to make money – not to build long-term successful companies.

Slide 41: “SAFE” Investment Instruments

SAFE agreements were originally created by Y Combinator of Silicon Valley and have become very popular in other markets. A SAFE agreement gives the investor the right to purchase shares of the company’s stock at some future point when the company issues Preferred Shares to investors. The price of the shares for the SAFE holders is determined when the Preferred Shares are issued’ usually at a discount. There are three major advantages to SAFE instruments. First, the company’s valuation does not have to be set when SAFE agreements are exercised. Second, the actual SAFE legal instrument can be very simple and require only minimal legal involvement. Third, for the company, there is no pledge of assets required to cover the case in which the company is not successful.

Slide 42: Convertible Notes

Convertible Notes are loans that have specific provisions that detail when the investment loan amount will be converted to shares of the company. The timing (when the note is due) and the rate at which the investment dollars are converted to shares is determined when the company’s valuation is set. In most cases, the valuation is set as part of the negotiation of additional (ex. Series A) funding. Unlike SAFE instruments, Conditional Notes entitle the Note Holders to the company’s assets if the company fails.

Slide 43: Convertible Note Advantages

Although more complex than SAFE instruments, Convertible Notes are far easier to implement than pure equity agreements. Also, they can be issued to and appeal to smaller investors, each investing a relatively small amount of capital. With the company’s valuation set at a later date, Convertible Notes are most applicable to early-stage companies whose potential is not fully understood.

Slide 44: Equity Agreements

First and foremost, an entrepreneur should never get involved in structuring, signing, shaking hands, or even their nodding heads with professional investors without being locked at the hip with a highly experienced attorney that has handled similar transactions in the past. There should be no exceptions to this approach. The term “equity agreements” is a catch-all term meant to cover investment letters of intent, term sheets, operating agreements, and shareholder agreements.

The most commonly discussed and, perhaps, the most misleading document is the Term Sheet. In its simplest form, this NON-BINDING agreement establishes the company’s value and the percent ownership that an investor is requesting. For example, an investor might say: “I will give you \$2M for 40% ownership of the company. This equates to a valuation of the company of \$2M divided by 40% or \$5M. More typically, a Term Sheet will contain dozens of other “minor” provisions that can have the effect of dramatically shifting the valuation and, in fact, the control of the company. In theory, a Term Sheet is used as the starting point for the preparation of the detailed Shareholder or Operating Agreement which will become legally binding on all parties.

An entrepreneur must always keep in mind that a financial investor's top priority (only priority?) is to maximize their investment return. In many cases, this may involve suggesting or insisting on draconian terms in their favor. Many of these terms seem innocent or non-consequential until they are enforced. An example of the impact of terms is shown later in this presentation.

Slide 45: Valuation

Without a doubt, establishing a private company's valuation is the most controversial aspect of all financial issues facing a startup. Rick Burnes, the Founder of the highly successful venture firm, Charles River Ventures, best summarized valuation: "A company is worth one dollar more than the second-place purchaser is willing to pay." There are several methods to "calculate" a company's value. The calculations may involve historical revenue, projected revenue, and profitability. Unfortunately, many startups may have less than impressive "numbers" that are often used against them as investors attempt to obtain more equity for their dollars invested.

To illustrate the fallacy of using standard financial metrics, consider the daily variations of publicly traded companies. Even with their long-term financial results that are audited and made available through the SEC, their valuations vary daily. The valuation of a public company follows Rick Burnes observation quoted above. For every optimistic buyer, there must be an offsetting pessimistic seller. It is hard to believe that the intrinsic value of a company varies day-by-day, or hour-by-hour, or even second-by-second!

An entrepreneur's time is better spent focusing on the terms of any proposed deal rather than the fictitious valuation.

Slide 46: Valuation "Methods"

The calculation methods listed on the slide can involve impressive, rigorous number crunching. However, all of them are based on certain "made-up" assumptions. An example of this situation is the valuation "calculated" based on the company's earnings multiple. The "earnings" may be a factual number from the company's financial statements but the "multiple" is an opinion set by the person making the calculation. The multiple could be justified as being similar to other companies in the same sector or companies at similar stages, or some other comparative metric. Unfortunately, "similar" is not the same as "identical."

Even though the earnings mentioned above can be a factual number, there could be significant variations in earnings based upon, among other things, the company's re-investment strategies. Earnings could have been dramatically reduced through investment in R&D, building distribution, or scaling operations.

The effect of attempting to use detailed calculations is similar to the proverbial "measuring with a micrometer, measuring with chalk, and cutting with an axe!"

Slide 47: Valuation Point of View

The point of view of an entrepreneur and an investor is commonly a major point of contention during valuation discussions. Company founders easily remember the sacrifices, trials and tribulations that they endured in starting and building the company. They naturally expect to be compensated for all of that hard work and the emotional rollercoaster that they have been on, often for years. Investors, considering investing in the company have an entirely different point of view. Their focus is their opinion of the future value of the company to others – either through an acquisition or a public offering. Although they are thankful and sympathetic to the founder's

past efforts, it is the forward projections are all that counts to them. Remember, investors invest to make money, not to look out for the best interests of the founders.

Slide 48: The “Deal”

The above situation can be summarized with an illustrative example that is not far from reality. This slide is similar to what happens in every episode of the popular television entertainment show “Shark Tank.” With a one-sentence “commitment” and a handshake or hug, a deal is “done” with the other terms to be worked out later!

Slide 49: Potential Outcome

In this hypothetical case, the company was sold to another company for \$15M. The entrepreneurs did a “quick” calculation based on the valuation commitment made by the investor and determined that they would receive their “fair share” of the proceeds which was \$9M. Unfortunately, when the dust settled, their “fair share” was reduced to half of what they expected! Why -- It was those “other terms” that did them in!

Slide 50: The “Terms”

This slide shows the “other terms” that had a direct impact on the disbursement of funds. The terms shown could vary considerably. The values shown are not best-case or worse case. Article 8.030201 available at the CxO-Atlas.com website includes an Excel™ tool that can be used to vary the terms shown.

In evaluating any proposed financing arrangement, an entrepreneur should take the time and spend the money to have an outside “deal expert” go through some scenarios to determine the impact of the “other terms” in a proposed financing. In most cases, the entrepreneur will appreciate the saying: “You set the price, I will set the terms.”

An entrepreneur should always assume that the investor’s committed valuation and the entrepreneur’s ownership will only be reduced by the terms of the deal – how much cannot be known unless a calculation based on many assumptions is made.

Slide 51: Terms Count!

This slide, taken from the model previously referenced, shows five different scenarios based on the deal terms. Of particular note, are the Angel Investor terms. Although Angels may require similar terms as VCs, in general, they are no where near as detrimental to the company as those from VCs.

Aside from the actual numbers associated with each of the terms, wording regarding when and how to apply them can have major impacts on the calculations. So, the exercise in projecting outcomes involves more than number-crunching; an attorney that can interpret the “words” is equally important.

Slide 52: The Lesson

The eight points listed on this and the next slide should be memorized and reviewed any time an investment discussion is held. Unfortunately, in the midst of the long and grueling fundraising process, it is easy to forget or discount these issues. It is almost guaranteed that in hindsight, an entrepreneur will regret NOT remembering them.

Probably the most common error that an entrepreneur makes is not understanding the overnight change in the relationship which will occur with “their” attorney. Before the deal, the entrepreneur’s attorney was focused on protecting the rights of their client – the entrepreneur.

However, once a shareholder agreement is signed, the attorney now must represent the rights of the company, NOT the entrepreneur. During “good times” this shift of allegiance may not be an issue. However, if the Board of Directors or shareholders and the entrepreneur reach an impasse, the attorney must represent the interest of the shareholders not the entrepreneur.

The same shift in responsibilities also occurs with the entrepreneur/CEO. They must represent the interests of the shareholders and not the employees. This situation becomes the most contentious when shareholder investors push for an earlier exit (to get their money out) than the CEO wants to do. The entrepreneur/CEO may want to continue to grow and expand. The “winner” of this argument is often determined by those “other” terms in the deal that did seem important when hands were shaken.

Slide 53: The Lesson

This slide is a continuation of the list from the previous slide. The last item, number 8, is often not understood by entrepreneurs. The majority ownership position, often under the control of the company, does not mean that they have control of the company. Once again, terms in the shareholder agreement can easily shift control to a minority shareholder such as a financial investor.

One example of the control that a financial investor can have involves their actions is future investments. If, for example, they threaten to not invest or not invest their pro-rata share, they are sending a message to potential new investors. Those new investors may feel that the existing investors, with their intimate knowledge of the company, are not investing in the new round, they must know something that is discouraging them. So, new potential investors may refuse to get involved.

Deal terms such as budget approvals and action approval by each class of stock can also provide minority control.

Slide 54: Get Investor’s Attention

In searching for financial investors, many entrepreneurs fall into the trap of thinking that it is a numbers game in which they try to carpet bomb the entire Angel or venture community. This approach does nothing more than waste the time of everyone, especially the entrepreneur. The resulting responses are similar to those when you receive a letter addressed to “Whom it may concern.” Most investors simply discard requests after skim-reading the subject line of an email or the first few words of a voice mail message.

Instead, an entrepreneur should do a substantial amount of filtering homework following the factors listed on the slide. Once complete, the next step should involve finding some method of making the request personal. An introduction or opening comment that will pique the interest of the investor will help to pass the first major “not interested” hurdle. Naming dropping works! Whether it is a mutual acquaintance, a recommendation, knowledge of how you are complementary to their portfolio companies, or investment thesis can get an investor’s attention. Any of these sources can be found with a little homework.

Slide 55: Get Investor’s Attention with One-Liners

Assuming you are able to get at least ten seconds of an investor’s time, start with one of the one-liners listed on this slide. Note the verb tense. All of the statements are in the past tense. This message is that the company has referenceable accounts and, therefore, the risk hurdle seems to have become manageable.

The reality is that if a company cannot factually make some of these statements, they are wasting their time pursuing financial investors except those few investors that are willing to consider pre-revenue or very early-stage companies.

Slide 56: Get Investor's Attention with One-Liners

Assuming that you are able to state, and an investor hears some of the one-liners listed on the previous slide, follow up with some of the one-liners listed on this slide. If successful, the investor may be willing to listen to more.

Note that neither slide mentioned the amount of money you are interested in raising. You must set the interest hook first. Of course, your planned request must be in line with the typical dollar investment ranges that the investors have made in the past. Asking Angels for \$10M is as inappropriate as asking VCs for \$100K.

Slide 57: The Three Most Important Numbers

There are several financial metrics that can be monitored to determine the status and likelihood of success of a company. However, for potential investors, three metrics stand out above the rest. They are the month-over-month increases in revenue, the amount of additional external funding that will be required to reach sustainable cash flow breakeven (CFBE) operations, and the length of time it will take to reach sustainable CFBE.

At first glance, if any of these three numbers are "out of whack" or not within the investor's "rule of thumb" of their primary investment thesis, they could quickly disqualify a company for further consideration. Probably the best example of this regularly occurs in the new medication or medical device sectors. Not only are these investments highly risky, but the time and effort involved in research and development, clinical trials, and regulatory approvals also places these investments well outside the majority of most investment firms. The same issues apply to companies planning to build new major manufacturing or energy facilities.

Slide 58: Number Factors

The "Net" Revenue Ramp refers to new customer revenue minus any customer turnover. Revenue can be one-time sales or recurring revenue such as SaaS sales or a combination of both. Clearly, the revenue associated with long-term customer commitments implies "stickiness" and less customer volatility. Also, implicit in the number is the market size and the company's growth vis-à-vis competitive alternatives.

The second critical number is the amount of additional external funding or cash required to fund the company until it reaches and can maintain monthly cash flow breakeven status. The amount of cash required will help an investor determine their investment strategy including future commitments and potential dilution. Although the amount of cash can be expressed as a single number, what areas the company is spending cash on is equally important. At one extreme, the company may not be investing properly to maintain its market position. At the other extreme, the company may be investing heavily in future offerings or obtaining market share at the expense of short-term profitability. Either extreme may be desirable based on many factors. In the past few years, some companies have followed a mega-growth through mega-spending model in order to obtain market share and market buzz. The hope of this strategy is to create high demand for their public offerings. In some cases, it has worked. And, in some of those cases, after the IPO and the investors have exited, the company's stock has taken a dramatic dive.

The third number is definitely related to the other two numbers identified above. It is the amount of time it will take to reach cash flow breakeven. There are two major considerations regarding this variable. First, the longer it takes to reach CFBE, the more opportunities there are for market factors to shift. Competition may catch up, overall economic conditions may change, or other factors, outside the control of the company, could occur that the company cannot effectively respond to in order to maintain their position. The second factor involves the investor's desire to more quickly reap the rewards of an early exit. A key metric that the limited partners of venture funds monitor is the Internal Rate of Return that they will experience from their VC fund investment. IRR calculations are significantly impacted by shorter return time frames. Investors may favor an earlier exit despite the company's belief that higher returns could result from the continued independent operation.

Slide 59: A Company Evaluation Tool

Although most of this presentation has focused on the financial aspects of startup companies and investors. The decision to make an investment involves several other factors. A simplistic statement that is often heard in startup circles is the investors invest in the team, not the business. This statement is probably most often repeated by "teams" that do not have a great business plan instead of investors! Of course, the team is important; a well-balanced mature team is key to the most critical factors that new companies face: Focus and Execution.

This slide lists the high-level categories that investors consider when comparing investment alternatives. An Excel™ tool has been created and is available on the CxO-Atlas.com website that lists these categories and the seventy-two underlying factors that should be considered. The tool described in article 3.020504 and other referenced articles, allows three companies to be compared side-by-side or three individuals to rate one company under consideration.

A simple five integer point rating scale is used for each factor. The composite results are shown as numerical averages for each category as well as an overall rating. A "5" rating represents the Best in Class. Any ratings at "3" or higher indicate that the company is worthy of consideration. Even with some ratings below "3," and an investor may want to continue to consider the investment. A good example of this situation is a company that, contrary to the "invest in the team" statement given above, is short some critical management talent. With funding, that void may be able to be addressed quickly.

The results are also displayed in a "spider" or "radar" chart as shown. This representation allows the user to quickly identify both strong and weak areas.

Although aimed at investors, this tool is probably more valuable to companies that are seeking investment. Candidly analyzing their company before talking to investors can allow them to address potential areas of concern before they are "discovered" by potential investors.

Slide 60: What They Are Watching For

During the fundraising "dance," entrepreneurs are constantly "selling" why their company is worthy of investment. Simultaneously, investors, knowing their poor track record of picking highly successful companies, are naturally skeptical. This interaction is common and normal. General Partners and seasoned Angel investors feel that they have seen and heard it all. And so, the dance starts and continues. Invariably, bad news, if it exists, and it generally does, will surface.

The context of Rick Burnes's quote is that when an investor senses one item/issue that may be suspicious, there may be far more bad news than has been discovered. Unlike fine wine, bad news seldom gets better with age.

Slide 61: What They Are Watching For

Some of the telltale signs are shown on this slide. It may be subtle or obvious, but many entrepreneur/CEOs attempt to hide or downplay bad news or items that do not appear to be in the best interest of investors. It never works. Remember, the third investor “R” stands for Relationships. More directly, it stands for Trusted Relationships. If investors lose trust in the CEO, their only recourse is to first use heavy-handed demands and, if that does result in the desired outcome, replace the CEO. Entrepreneurs and CEOs must always remember the Investor Golden Rule: “He who has the gold makes the rules.”

Slide 62: What They Don't Say

The title of this presentation is “Inside the Head of Investors.” Many items/issues that are “inside investors’ heads” are not directly verbalized. This slide and the next five slides summarize many of these usually unspoken thoughts. The points made on these slides are not meant to be negative and certainly not evil. Instead, they reflect the reality that investors encounter on a regular basis. Remember, even with their experience, expertise, and due diligence, poorer than hoped for company performance is the norm, not the exception. Investors WANT every company to succeed in order for them to receive exceptionally high returns. However, they do not share your passion for your business – they cannot afford to!

Slide 63: What They Don't Say

At the risk of being overly dramatic, paraphrasing a line from the movie *The Godfather*: “It is nothing personal, it is only business” as they execute an ex-colleague!

Slide 64: What They Don't Say

Slide 65: What They Expect

Investor expectations can be summarized as the desire to hear candid, factual assessments of all aspects of the business. After the assessments are given, investors want to hear the company’s plans to address any issues that have surfaced as well as the plans to continue the execution of the positive elements in the business. Based on their experience, they will comment accordingly. Investors expect the company to run the company with them, only providing guidance.

Although the company is the most important thing to the entrepreneur/CEO, it represents only one of a dozen or so companies to the investor.

Slide 66: How They Will Judge You

Investors simply expect you to do what you have said you will do that will have the impact of making money for them – it is just that simple. How hard you are working and the problems that you are facing don’t count. Investors expect you and your staff to be working hard and to meet and resolve the daunting challenges that every new company face. Investors will listen and express gratitude for your efforts but will still expect you to meet THEIR goals of providing superior returns.

Slide 67: Important Points to Remember

This lengthy presentation covered a wide variety of issues regarding financial investors. This slide and the next list ten key summary points that every entrepreneur or new company CEO should keep in mind before they consider beginning the arduous and frustrating task of raising money. Without a doubt, the earlier the stage of the company, the more difficult it is. Every hour spent on planning and then pursuing fundraising is an hour NOT spent on building the business. The

almost always fatal “logical” trap for an entrepreneur is to believe that “I know what to do, all I need is the money to do it!” It is never true!

Slide 68: Important Points to Remember

This may sound egotistical, but with certainty, I can say that if you do not follow the advice of this and the previous chart, at some point you will look back and regret it.

Slide 69: CxO-Atlas Website Article Organization

This presentation, given several times, is based on the material included in the www.CxO-Atlas.com website. Access to it is free. This presentation can be downloaded from the site. It is in Volume 8, Chapter 4, Article 8.040803.

A list of some of the relevant website articles to this presentation is shown on the next slide.

Slide 70: CxO-Atlas Website Suggested Articles

The articles shown on this slide are from the www.CxO-Atlas.com website. It is suggested that the reader review the articles listed in the order shown. After reading one of the articles, the user may also wish to browse both “next” and “previous” articles through the associated buttons shown at the bottom of the article.