on Target consultants

# Bolotin Points

Newsletter

*Providing Actionable Ideas to Increase Your Profit*

Vol. 1
Issue 5
12-22-08

Due Diligence · Go to Market Strategy & Execution · Revenue Acceleration · Partnering & Asset Sales

## Investors

How to Be Like Them, Think Like Them, and Sell to Them

If you are seeking an investment in your company, this newsletter is written for you. Overall, the goal of this newsletter is to help you to "sell" your investment. In order to do this, I will help you to gain a better understanding of the investment process by providing you with an outline of what investors look for, how they think, and therefore, how you should proceed.

As is the case with any good sales process, this one begins with a definition of the target prospect; in this case, the investor.

definition

**investor** *n.* Anyone who provides resources (typically, money) to fund your company. This includes traditional venture capitalists ("VCs"), "angel investors", friends and family. Very importantly, it also includes you.

Why do I include "you" in my definition of an investor? Because you're the person who provides the most resources, and typically has the most to win or lose.

How investors look at potentially making an investment in your company is the same way you should look at making an investment in your company. Why? Because you're the biggest investor of all—some or a significant amount of your money, an enormous amount of your time, your reputation, etc., all are on the line. One could even make the case that your gains or losses are significantly more extreme than those of your professional investors. While professional investors are typically diversified among several and somewhat disparate investments, you're probably invested almost 100% in only one--yours.

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Before trying to talk investors into investing in your company, ask yourself the question, "Do I want to invest in my own company?" You should employ the same thinking that potential investors use. Don't fall in love with your company and / or idea any more than would a rational investor. Please don't forget that you're the biggest investor of all, and, therefore, you should decide very carefully whether or not to invest.

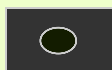
Relative to getting others to invest in your company, let's start with the fundamentals. In the best sense of the word, you are "selling" an investment in your company to potential investors.

In this instance, I define "selling" as a process that, at a high level, contains the following steps, which must be executed in order:

## Step [ 1 ]
## Define Your Target Market

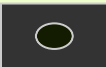
As in any sales process, to define your target market, identify and find the prospects who are the most likely to give you what you want.

The major classes of funding sources are defined below.




**venture capitalists (also known as "VCs")** *plural n.* Professional investors who typically manage a fund for the purpose of generating returns for their investors. VCs generally make money from the management fee (typically a percentage of the money they're investing), plus a portion of the eventual profit from the investments they make in companies like yours. This profit almost always comes only when one of their portfolio companies (the ones they've invested in) are acquired or "go public."

**angel investor (also referred to as "angel")** *n.* An angel investor must be "accredited", which means that he or she meets certain requirements for minimum investible net worth and / or income. Angels many times are former business owners or otherwise successful businesspeople. Sometimes, angels form clubs so they can group together to see and review investments while gaining from the participation and insights of other angels. Sometimes, they also invest as a group, but most often, they invest as separate individuals.




**friends and family** *n.* People who believe in you, because they know you.

The table on the next page provides some very high level rules of thumb that each investor class will <u>tend</u> (not always, but "tend") to look for in order to decide whether or not to make an investment.

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| Item | VCs | Angels | Friends, Family, Etc. |
|---|---|---|---|
| **Initial Investment Amount** | $3+ million. | Generally, around $25,000 or more each, but can vary widely. | Anything they'll give you. |
| **How Near "Cash Flow Positive" Your Company Needs to be Before New Investment** | At or near. | Earlier than VCs. | Anything they'll agree to. |
| **Geographic Location of Company** | Near or at the same city where the VC is located. (VCs "cluster" around areas like Silicon Valley and Boston, while not tending to cluster around areas like Tucson.) | Very near or at the same city where the angel is located. (However, angels are not as geographically concentrated as VCs.) | Can vary widely depending on the criterion of the investor. |
| **Referral Source** | Almost always from a trusted source. (VCs receive many more requests for investment than they can reasonably process, so they tend to rely on sources they trust for their "deal flow".) | Preferably referred by a trusted source, but not as determinative as for VCs. Many angel groups even have a screening process whereby almost any company can try to get past the first filter. | You probably know them already, or, at most, are one referral source removed. |
| **Management Experience** | Strong preference for management that has already proven itself in the same circumstances as would be required to execute the plan to the liquidity event (defined later). | Strong desire for management that has already proven itself in the same circumstances as would be required to execute the plan at least to the next funding event. | They probably think that you're pretty capable. |
| **Amount of Time Invested Money Needs to Last** | The size of the investment funds available to VCs generally enables them to set aside money for future rounds, so they tend not to be overly concerned that the initial investment money may not be sufficient to take the company to cash flow positive. | Angels tend to have smaller resources than VCs, so they will tend to want their investment to last until your company is cash flow positive, or, more likely, to until additional investment can be secured from a VC. | Generalizations are difficult to make. |

Be honest. As you look at the three classes of investors above, which class best de-


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scribes the investor class most likely be interested in your company at its present stage?

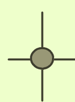
Please, remember to go about "selling" your investment just like you should go about selling your product. Don't waste your time trying to sell a product that does not match the prospect's criteria. When you are looking for investment, your time is extremely valuable. Again, don't waste it.

Now that you've defined your target market by deciding which investor class to pursue, it's time to consider the next filter.

## Step [ 2 ]

## Narrow Your Target to the Investment Source Most Likely to Understand Your Business

Each prospective investor will have a set of preferences, abilities and experiences that is suited to a particular type of investment. For example, some investors will specialize in e-commerce, others in alternative energy. The same is true (to the extent that they don't invest in you just because you're you) for friends and family. Don't waste your time trying to get an investment in, for example, your start-up healthcare software company by talking with investors who specialize in light manufacturing.



**how to test this:** Check the prospective investor's web site; most will tell you their criteria. If the web site is silent on this point, look for guidance by examining the prospective investor's portfolio companies listed on their site. If this doesn't work, call up and ask.

Now that you've sufficiently narrowed down your target, it's time to execute the final step in the process.

## Step [ 3 ]

## Communicate in a Way Your Prospective Investor Will Understand

Like any good sales process, you'll have to understand your customer's (investor's) objective. To do this, you'll have to understand how an investor thinks. Most of this is fairly straightforward: they think like you would think, if you were in their position.

Let's consider it from the investor's perspective. The way we'll do this is to pretend that you're the investor and I'm the one making the pitch to you on behalf of my start-up company. Here's what I'm asking you:

- Please give me $1 million of your money.
- I'll give you some portion of my company in equity, but I won't give you any day-to-day management control.
- The only way you won't lose all the money you've invested in my company is if I'm successful and there's a liquidity event, so you'll have to depend on me. (See definition of "liquidity event" below.)
- Can you write me a check by next Thursday, because I need to make payroll?

As an investor, does this seem like a good deal to you? As an investor, how comfortable are you with this deal?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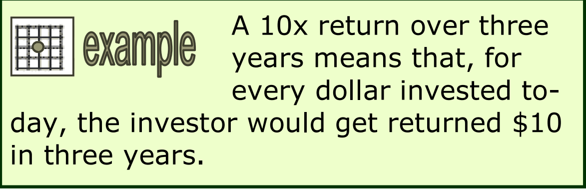
If you're honest with yourself, you'd have to say that almost any investment is a great leap of faith for almost any investor. However, investors do make investments, and they do so based on how they evaluate an investment. Let's look at that next.

At the highest level, investors seek to generate the greatest financial return possible. In our example, we will assume that the investors seek a fairly standard 10x return over three years.



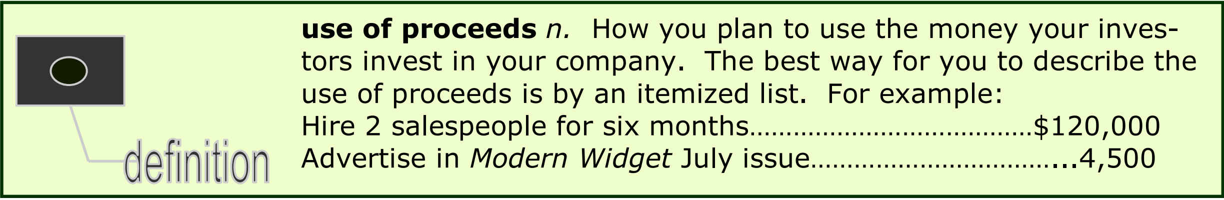

A 10x return over three years means that, for every dollar invested today, the investor would get returned $10 in three years.

You may ask yourself why the return has to be so high. Shouldn't the investors be happy with a return of anything over the rate of T-Bills?

The reason the required return is what it is, is that a great majority of all companies investors invest in either fail outright (causing the investors to lose 100% of the money they invested in that company), or bring back a small return. Therefore, the companies that succeed must cover the loses of the ones that don't. Not easy.

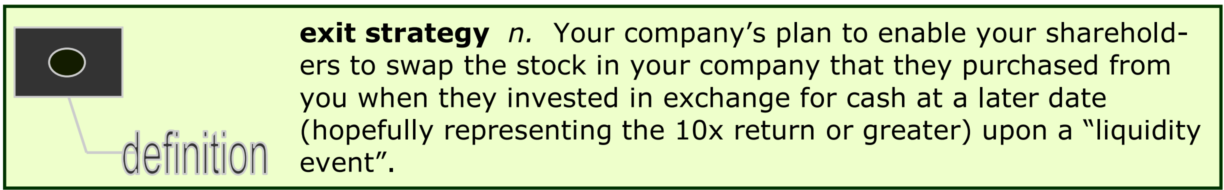
How do investors assess the possibility of a 10x three year return?

First, they look at your business plan. In the plan, they're looking to find out what problem you solve (sometimes referred to as "what's broken"); can someone make money solving the problem; to what extent it is believable that you and your team are that "someone"; and how you would use the investment you're asking for to execute the plan. This final item is called a "use of proceeds". (For a list of questions to answer about your ability to be successful in a market, please see my September 15, 2008 newsletter, *4 Minutes and 2 Steps to Maximize Your Profit.*)

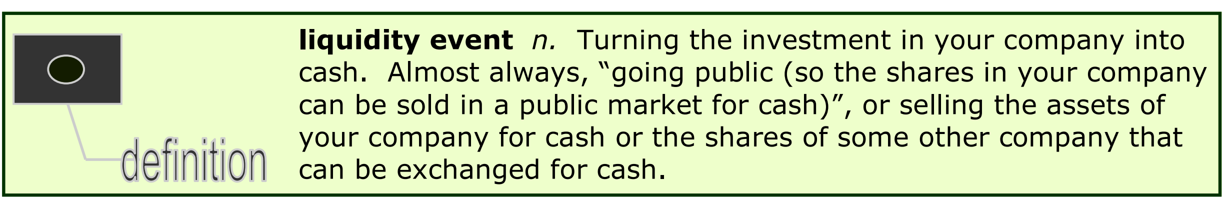



**use of proceeds** *n.* How you plan to use the money your investors invest in your company. The best way for you to describe the use of proceeds is by an itemized list. For example:
Hire 2 salespeople for six months……………………………….$120,000
Advertise in *Modern Widget* July issue…………………………...4,500

If the investor believes in your business plan, he or she would next look at the way he or she would participate with you. Before understanding his or her specific return, the investor would seek to understand the overall return for the company's shareholders. This includes understanding your financial projection, exit strategy, and your projection of the terminal value of your company.




**exit strategy** *n.* Your company's plan to enable your shareholders to swap the stock in your company that they purchased from you when they invested in exchange for cash at a later date (hopefully representing the 10x return or greater) upon a "liquidity event".




**liquidity event** *n.* Turning the investment in your company into cash. Almost always, "going public (so the shares in your company can be sold in a public market for cash)", or selling the assets of your company for cash or the shares of some other company that can be exchanged for cash.

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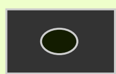
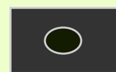
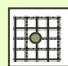



**terminal value (also known as "liquidation value".)** *n.* What the company is worth when it is acquired or goes public. This is equivalent to the total return to the shareholders of the company.

Next, investors look at the return they would get for themselves. Primary among this understanding is your post money valuation.

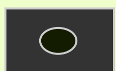



**post money valuation** *n.* The value of the company directly after the investment is made. Typically, this is equal to the total quantity of shares issued (including the investment) multiplied by the price paid per share by the most recent investor.



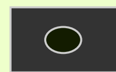

If, after you receive an investment of $1 million, your post money valuation is $4 million, the investors making the $1 million investment will own 25% of your company. In order to get a 10x return, the investor's $1 million investment would have to return $10 million. In order to do this, your company would need to have a terminal value of $40 million.

Now that we understand this, let's consider how investors judge the likelihood of receiving their 10x return. In order to do this, they assess what they term as "risk".




**risk** *n.* Numerically, one minus the degree of certainty to which the investor believes that the objectives of the category will be achieved. For example, if the investor believes there is a 60% chance you will achieve a certain objective, the risk is 40% that you won't.

In order to assess risk, a good investor will conduct "due diligence".




**due diligence** *v.* The act of assessing risk in order to determine the likelihood of a company achieving it's objectives, and ultimately, the return for the investor.

Below is a high level list of the types of risks an investor will typically assess during due diligence:

**Technology Risk**. If your product is not 100% finished, can you finish it, and will it work? The best way to eliminate this risk is to have a finished and working product. If it is not finished, there is always some risk that it can't be finished. If it is finished, there is always the risk it may not work.

**Financing Risk**. Does the investor have enough money to finance your company until it is cash flow positive? If not, he or she will have to work with you and successfully bring in additional financing, because if you don't, you will go bankrupt and the investor will lose all his or her money.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**Execution Risk**. Can your management team execute the plan as written and / or can deal with the changes that are likely to occur? Have you proven you can do this, or does the investor just have to trust that you can learn on the job and be up to any challenge? Are you the type of person who could be coached? If not, are you willing to bring in other management and perhaps take a secondary role?

**Market Risk**. Have you sold any of your finished products to disinterested third parties at full price? If you haven't, there is a risk you may not be able to.

**Competitive Risk**. What do you have that is unique? What is the likelihood that your competitors will win, instead of you? What is the likelihood that your value can be replicated by competitors? How "protectable" is your business? What are the "barriers to entry"?

As a result of conducting due diligence, a good investor will decide how likely it is, in their judgment, that you will achieve the desired return. If, after the risk is calculated, you meet the investor's criteria (remember the 10x over three years?), you're on your way to negotiating a deal.

Given what you've just learned, how do you apply this when you present to an investor?

Present to investors in the way that they think about making an investment. First, clearly and concisely describe your business. This includes what problem your company solves, what is special about how you will solve it, how much money you will make, and what would cause someone to believe you can do it. Then, clearly and concisely describe the financial terms for the investor. This includes use of proceeds, your post money valuation, what equity you're willing to give for what amount of investment capital, estimated terminal value and exit strategy. Do all of this and virtually nothing else. Why? Because this is the information the investor is looking for.

Following the technique outlined above will greatly increase your chances of success. Here are the two main reasons why:

1) Doing so will reduce the frustration most investors feel as they listen to most presentations and try to "ferret out" the relevant pieces to put them into a form whereby they can make a decision.

2) Very importantly, you will come off as reasonable, capable, professional and credible. (Just the type of individual, all other things being equal, that others would like to invest in.)

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In the next issue, we'll discuss dealing with objections.

About Chuck Bolotin

Chuck founded, funded, operated and sold two companies. The On Target Consultants Process™ he developed, and the success he has achieved applying it has made him an expert in bringing products to market in virtually any vertical, many times when the target market is not known in advance.

Chuck is available for talks to your organization as well as personalized consulting assignments.



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