Do You Have an Investable Business Case?

Your Story Versus What VCs Really Want to Hear

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I. Setting the Stage

This paper is written primarily for first time entrepreneurs who have a start-up business opportunity and are wondering if it's "investable". There are many very successful business in the marketplace but that doesn't mean they are, or were ever, deemed investable by professional investors. So, what exactly consititues an investable business opportunity?

The next few pages address that question. But rather than just provide a list of criteria, this paper stages a first meeting between an entrepreneur and a venture capitalist (VC) and looks carefully at the story the entrepreneur tells versus what the VC really wants and needs to hear.

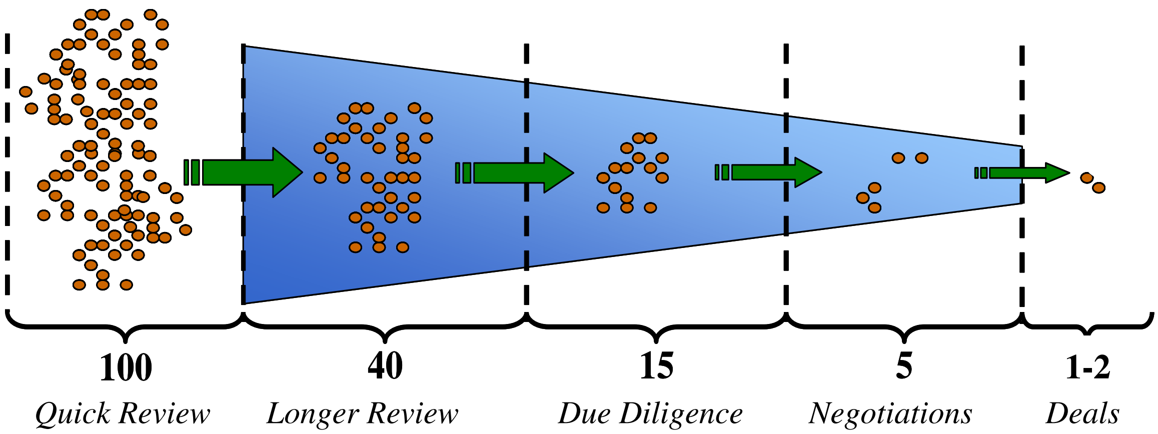
The reader should note upfront that the paper does have a high-tech bias because that is indeed the bias of venture capitalists. Most VCs nationwide prefer investing in high-tech versus low-tech companies. The paper is also biased towards the seed and early stage which means we'll be assessing whether a company is investable or not in its earliest stages of development.

So, let's set the stage for the meeting that's about to occur and introduce the characters. On one side of the table is the inventor and potential entrepreneur who has been working away in their research lab for five to ten years. Finally the day arrives and they have a laboratory prototype. It's big and clunky and ugly and has wires protruding in all directions, but it proves that the technology actually works! And it's protected. There are patents issued or pending. The entreperenuer thinks it has commercial potential. In anticipation of this day, they connected a few months earlier with their local business school professors, or Tech Transfer officers, or local incubator coaches, or community consultants who helped them with an opportunity analysis. They've assembled a twenty minute investor presentation and maybe they've even write a preliminary business plan. The story about the business opportunity is starting to sound reasonable if not compelling. Their next steps will be to conduct beta tests to prove that their technology works in the "real world". Maybe they're ready to validate that it can be manufactured. Maybe they need to start executing on a commercialization plan and securing their first customers. But they need money!! In fact, significant amounts to last twelve, eighteen, twenty-four months. They've already invested several thousands of their own money to get to this point, but there's simply no way to boot strap this budding business operation with their own cash. They're looking at half to two million dollars just to get out of the starting blocks. They want and need venture capital!

On the other side of the table is the venture capitalist, a professional investor. VCs are in the business of investing "other people's money" on high-risk companies. But they don't just invest. They are also obligated to bring back a high return on that investment regardless of the economic climate to their LPs (limited partners) who have put money into the seed or early stage fund with the expectation of a 30-40% IRR within 5-7 years. As high risk investors, VCs know the statistical odds for the success and failure of these very early stage companies. They know that some of their portfolio companies will undoubtedly fail. So that means that the returns for the ones that succeed will have to make up for the ones that fail. They also need to provide returns on that portion of the fund that was used for management fees and never even invested. So, the only way they can achieve the expected IRR for the fund is to achieve 60-90% IRRs on the big winners. But since they can never be sure which ones will end up as the big winners, they need to have a significant equity position in all their companies. So a large part of a VCs job is to carefully screen and select companies for investment that they the think have the potential to win big. And then they need to negotiate a significant equity stake in each. So, how do VCs separate the wheat from the chaff?

II. The Filtering Process

VCs start with hundreds of potential deals annually. Statistics suggest that for every hundred opportunities assessed, more than half are rejected after a twenty to thirty minute scan of a business plan or executive summary or after a brief conversation because there is some fatal flaw. It's a one-trick pony company. It's a life-style business. The market size is too small. The competitive landscape is too crowded. Since they obviously didn't meet "the criteria", about 60% are rejected before they pass through the first gate.



However, about 40% might make it to a longer review, possibly a first meeting, after which another 25% are rejected. Only about 15% make it to the due diligence phase where they are investigated in-depth. But then only 5% are deemed "investable" and engaged in negotiation. More than half of those negotiations fall through and less than 3% (only one or two) agree on terms and an investment is made. [1]

Specific numbers may vary for VCs depending on their mission and geographic location, but in all situations, the serious vetting of a deal by a VC starts with the first meeting. So, let's put a VC and an entrepreneur together in a first meeting and let the vetting begin.

III. The First Meeting

Hopefully, the entrepreneur has been properly coached on how to give an investor presentation. The basic format includes a discussion of the company, market, technology, competition, operations, and financial potential. These sections with suggested content are represented in the boxes on the following pages in the left hand columns. We'll be working through these sections in sequence and juxtaposing the typical presentation content with what VCs really want to hear.

[1] Pratt's Guide to Venture Capital Sources, 1997, pp 23-28

The Company. The entrepreneur needs to keep in mind that this is fundamentally a story about their company. So, it only makes sense that should start their presentation by introducing their company. Entrepreneurs should explain the type of company they are and (very simply here) the product they will sell. For example, maybe they're a new biotech company and they have a new HIV therapeutic. Maybe they're an optics instrumentation company and they have a new optical measurement device. VCs want to hear that the entrepreneur is clear on what they are and what they've got. It's amazing how many entrepreneurs can talk for five, ten, fifteen minutes without ever identifying what it is that they have. This shouldn't be difficult – it's a drug, a device, a service, an algorithm.

They should also talk about their background because VC want to hear where they're from and why their credible. For example, maybe they're a researcher at a reputable university and they've been working on this technology for ten years and the NIH, DoD, or DARPA has invested millions in the development of their technology. Investors want to hear that. This tells an investor that NIH, DoD, or DARPA believes the entrepreneur is onto something significant since they've provided capital. It also tells them that one of these federal agencies has taken technology development risk. Investors are willing to take commercialization risk but they really don't want to take technology development risk.

Maybe the entrepreneur has been at a large corporation like Kodak and Kodak has invested millions in the development of the technology but cancelled their successful program because it was "non-strategic." Again, that means that Kodak has taken technology development risk and often in cases like this, the technology is already quite mature. Now, the entrepreneur reports that they've licensed the technology from Kodak and are launching their company. That gives them a lot more credibility than if the technology was developed in their basement or garage and there's still technology development work to be done. Seed investors shy away from those situations. It's too risky.

In addition to being clear on what they are, what they're got, and where they're from, it's also important that the investor hears the entrepreneur talk about where they're going. Entrepreneurs should attempt to provide a mission statement. Where do they think this Company will be in five to ten years?

Here's the summary of the first section of the presentation. If the presentation is only twenty minutes long, this might constitute the first slide:

The Company	What VCs Want to Hear
• Type of company and product • Background • Mission statement	Clear on what you are and have, where from (why credible) and where you're going.

The Market. Now, that the product has been identified, entrepreneurs should talk about who they're going to sell to. While they need to identify their target market segments, what VCs really want to hear is that there is pain in those market segments. Entrepreneurs need to talk about the current offerings and their deficiencies and explain in a powerful way, that the status quo is inadequate. This is the first hook to getting a VC interested. The first and most important thing investors want to hear is that there is a significant market need. Generally, they don't even care what an entrepreneur's got until they know there's a need for what they've got. The most common reason given anecdotally for a failed business is not that the technology didn't perform as promised but that it failed in the market. The best way to avoid that trap is to make sure from the get-go that customers really, really want this. Probability of success is increased when the market pulls a product in versus when an entrepreneur pushes it in.

Keep the following elements in mind for the second section of the presentation. For a twenty minute presentation, again, this might constitute only one slide:

Market Opportunity	What VCs Want to Hear
• Target market segments • Current offerings & deficiencies • Market need !!	Pain !! Status quo is inadequate. **Significant market need !!**

Once the entrepreneur has established market need or identified a problem, then they need to move on and proclaim that they've got exactly the solution that the market is looking for.

Technology. Entrepreneurs need to make sure the explanation of their technology is clear and concise. Investors generally don't want or need the technical details -- no NDAs should be required. They just want to hear that the entrepreneur has the solution to the problem they just described. Then ideally, they would explain how they're going to create an entire portfolio of products because they have a platform technology (since VCs generally don't invest in one-trick ponies). They need to make sure that the practical applications of their technology are well understood by the investors. They need to talk about the strength of the intellectual property, i.e., how may patents they have and if they've issued. VCs want to know that the technology is well-protected by IP which will create barriers to competitors that might be trying to do the same thing. The next slide should include the following elements:

Technology	What VCs Want to Hear
• Clear, concise explanation • Product portfolio • Practical applications • IP Position	**You've got the solution !!** A platform technology. Well-protected; good barriers.

And then the entrepreneur should move on and talk about competition.

Competition. Hopefully, entrepreneurs have built a comparison matrix of competing technologies. It should be very clear from that matrix that no one else has "the solution" (or that there is room in the market for a few good competitors.) Their competitive advantages over the competing technologies should be well spelled out and they should be compelling. They need to identify other vendors of similar technologies and the threat that they pose to the company. Hopefully, they're not planning on going head to head with GE Medical Systems, or Motorola, or Intell. Investors want to hear that the competitors are manageable. The next section might require two or three slides:

Competition	What VCs Want to Hear
• Comparison matrix • Your competitive advantages • Threat from other vendors	**No one else has solution !!** Compelling. Competitors manageable.

Business Strategy. In the beginning, the business strategy can be as simple as: This is our first product. These are our first customers. And here's how we're going to get that product to those customers. Investors want to hear that there is focus coming out of the starting blocks and that there is easy access to customers. Here's the next slide.

Business Strategy	What VCs Want to Hear
• Prioritized products • Targeted customers • Distribution channels	There is focus. Easy access to customers.

Operations Plan. In their operations plan, which might require three to four slides, the entrepreneur must identify their management team. VCs want to hear that there is a team to take this forward. The entrepreneur needs to explain the R&D and business development timelines and milestones. VCs want to hear that the puppy is ready to take a walk since they don't want to have to feed the puppy for a long time until that day arrives. They want to hear that their technology/product is market ready now or very nearly market ready. Staffing and infrastructure plans need to be explained so that the investor can get a sense of what the company will look

Operations Plan	What VCs Want to Hear
• Management Team • Timeline and milestones • Staffing and Infrastructure plan • Use of funds	Team to take this forward. Puppy's ready for walk. Value-increasing milestones !!

like, how it will scale over time, and the amount of additional financing that might be required. They want to see that their investment (generally the first money in) will be used to achieve value-increasing milestones. Using funds to build or manufacture a commercial-grade product is an early value increasing milestones. Getting a first big customer like Motorola is a value increasing milestones. Using funds to pay the CEO and CTO big salaries generally is not.

Business Potential. For the opportunity to be deemed investable, the VC needs to hear that market size for the new technology/product is at least a quarter of a billion dollars. The Company's share of that market should be somewhere between 1 and 100%. If the entrepreneur says that they're going to capture 100% of a market and not have any competition, then that will sound bogus. On the other hand, so many entrepreneurs don't realize how bogus the "1% thing" sounds. "The size of the market is $30B and all we need to do is capture 1% and our revenues will be $300M!" Rather than being impressed, the VC generally reads this to mean that the entrepreneur hasn't sized their market properly or hasn't sized their market segment properly. Their financials should indicate that the company can make some serious money, and serious money generally means at least $30-40M in annual revenues after the Company stabilizes. Entrepreneurs then need to describe their exit strategy, preferably that an acquisition by a major player is likely (since the number of IPOs is down dramatically since the "bubble years") with good IRRs for the investors. Two slides might be required to convey all this information.

Business Potential	What VCs Want to Hear
• Market size	>$250M
• Company share	Not 1% or 100%
• Financials	**We can make serious money !**
• Exit strategy	Acquisition likely w/ good IRRs

Validation. Finally there is validation, validation, validation. This is so important and unfortunately so many entrepreneurs stop short of any type of validation of their investor presentation and/or business plan. Investors know that the entrepreneur thinks that their technology/product/opportunity is the greatest thing since sliced bread, but they really need some validation of that from objective sources.

Validation	What VCs Want to Hear
• Beta test results	This works outside the lab!
• Comparables	This business model works.
• Market Survey	Customers want this.
• Quotes !!	Others think this is a good idea.

If there are beta test results that *validate* that the technology actually works outside the lab, then investors want to see that. If there are stories about similar businesses that *validate* that the business model works, then investors want to hear that. Hopefully, the entrepreneur has conducted a market survey and they have results that *validate* that customers really want this. They should report this to investors. Maybe they already have LOIs. That's hugely validating. They should collect and include the best quotes possible in their presentation from other technology and industry experts that also believe and can *validate* that this is a great opportunity.

If four slides are required here, the entrepreneur should go ahead and take the time and space and conclude their presentation on a high note. In fact, during due diligence, VCs will be trying to validate the entrepreneur's story so the more validation the entrepreneur provides up front the more likely it is that they'll pass through the "next gate" to the due diligence phase and the more likely the due diligence will be streamlined towards a positive outcome.

Review. So, with all the interruptions and questions by the VCs, the entrepreneur's "twenty minute presentation" has taken at least an hour. Now, the first meeting is over. For an opportunity to be deemed investable, investors must have heard the following:

- *There is a market need.*
- *The entrepreneur has the solution to the market need*
- *No one else has the solution (or there's room for competition)*
- *"We" can make some serious money here.*

These are the four most important criteria. Hopefully, the investor has also heard that:

- *This product is ready (or just about ready) to be commercialized*
- *There is a team to take it forward.*
- *And there is a plan to take it forward.*

Seed investors are generally more flexible and forgiving on the last two points than later stage investors. The team is generally a hugely important criteria for VCs, but since seed and early stage companies are still in the formulation stages, there might not be a complete management team yet. Seed and early stage investors must at least have the confidence that they can assemble an effective team around the entrepreneur. And if the business plan isn't nailed down yet, then investors must have confidence that the details can be worked out and that the team moving forward on this can architect an effective plan.

So, that summarizes the most important "hard criteria" that must be met for an opportunity to be deemed investable but let's not forget that the "soft criteria" is also extremely important.

Soft Criteria. The entire time the entrepreneur has been talking, the VC has been sizing them up. The VC is trying to decide if *the entrepreneur* (not just the opportunity) is investable.

Here are some of the soft criteria used by VCs:

- The entrepreneur can recruit the right people for the Company

- They're a team player
- They're very smart with high integrity
- They listen!
- They value the VC's contribution besides money
- They have the same exit strategy as the VC
- The investors can work with them
- The "chemistry" is right

The last two bullets deserve particular emphasis. The chemistry really needs to be right between a VC and an entrepreneur. Both need to believe that they can work with each other, because prior to any liquidation event, they will be working together for a long time.

So, if the opportunity looks good and the chemistry is right, then the entrepreneur will likely pass through the "next gate" into the due diligence phase.

IV. Due Diligence

The reason the entrepreneur has arrived at the due diligence phase is because they've told a good story. Due diligence by the investor is really largely about validation, validation, validation. The investor must validate that the entrepreneur isn't a few cards short of a full deck. But rather that all the elements of the story are actually as stated or better. The VC and their staff must check the internet for similar technologies and vendors. Basically, they need to scope out the competitor landscape. They need to access market research reports to validate market size, market potential, and market trends. (The entrepreneur should have some reports to pass along.) They should spend some time searching www.uspto.gov to understand what's already been patented that could potentially hurt or aid the company. (Sometimes potentially competing patents can be licensed into the Company.)

They need to ask the entrepreneur for contact information for some technical and industry experts and make calls to validate the product and the opportunity. They should contact (with clearance) their potential customers to validate that their customers really want this. The VC will likely consult with their own experts since most have a network of technical or industry experts that they can call upon. They will likely check prior documentation, e.g., license agreements as well as capitalization tables to determine who owns what and who's properly motivated to work toward company success. They will compare notes with other angels/VCs if they are syndicating the deal. The more eyes on an opportunity, looking at it from different perspectives, the better. Although generally hard numbers are difficult to come by with seed and early stage companies, who really have no track record of operations and revenues yet, the VCs will use as many numbers as possible to do "the math" to determine their required equity and potential returns on their investment.

If VCs are still positive after their due diligence, then they will likely negotiate terms and make an investment in exchange for equity ownership and some control via a board seat. After the investment, all company stakeholders start working very hard for a big win.

V. Conclusions

The introduction to this paper suggested that it was written for entrepreneurs who are wondering if they have an "investable" business opportunity. If, at this point, after a careful reading, an entrepreneur is persuaded that they *do not* have an investable business opportunity, that doesn't mean they don't have a business. They could have what's called a "life-style" business. These are typically slower growth enterprises where family and friends provide funding to launch the business and/or the entrepreneur "boot straps" the organization. Over time, the company can generate enough revenues that the owners have a very comfortable life-style but they usually don't achieve the "big wins" that investors require.

On the other hand, if after reading this paper, the entrepreneur is persuaded that they *do* indeed have an investable business, then they have several funding options. Venture capital may not be their first option. Since the earliest money from professionals is the most expensive, entrepreneurs might want to use their personal financing for a while. In fact, many investors like to see that an entrepreneur has put skin in the game. Entrepreneurs can tap family and friends. They can apply for SBIR grants. Or they can seek out Angels.

As the company matures, and the entrepreneur needs major infusions of capital, then they'll probably seek out VCs since they generally have the deepest pockets. But venture capital is not free money. In fact, it can be very expensive in terms of the amount of equity an entrepreneur has to give up. Nevertheless, there are statistics that validate that Companies that have received venture capital financing have outperformed their industry peers[2]. In fact, for some companies, it would have been impossible for them to have ever achieved "the big win" unless they had accepted the kind of "big money" that VC's can provide.

This paper was actually written as a prequel to another paper that digs deeper into the ins and outs of venture capital. If an entrepreneur is likely to seek such funding, then they might want to download the white paper "Before the Negotiations: What Entrepreneurs Need to Know about Seed and Early Stage Venture http://www.excellny.com/index.php?page=white-papers which attempts to prepare an entrepreneur for the road ahead, if that's possible.

The road ahead is not easy. As the odds attest, raising capital, especially in the earliest stages of a company's development is very difficult. The availability of seed and early stage capital continues to be very limited in all parts of the country because this is very high risk investing. That may explain why VCs have been trending upstream towards later stage funding since the telecom and dot-com "bubble" burst in 2000[3]. These trends suggest that the lack of capital for companies in their earliest stages will only get worse.

Fortunately, Angels have started to organize networks nationwide to fill the void. Also, many states are starting state-supported pre-seed, seed, and early stage funds which are managed by investment professionals. While the funds are technically not-for-profit, they are usually managed as for-profit, so that returns make it "evergreen". Some states, such as Pennsylvania,

[2] "Venture-backed firms out-perform peers", Pioneer Press, July 2004
[3] "VCs Arriving Later", Wall Street Journal, November 9, 2006

Maryland, and Massachusetts have had such funds in place for a decade or more, and have proven this model successful.

Since entrepreneurs are needed to revitalize the economy in many parts of the country, it is important that they press forward with their dreams and opportunities. And VCs, especially local and regional VCs, need to continue raising venture funds (hopefully some at the pre-seed, seed, and early stage) to deploy capital to entrepreneurs in search of financing. And private partners, as well as local and state government, need to institutionalize their support of the venture funds for personal as well as community gain. It's not easy on any side of the fence. But no guts, no glory.

Happy venturing to all.