

WEDNESDAY 13.09.06

# REPORT ON BUSINESS

|                                                                                                |                                                                                     |                                                                                          |                                                                                                       |                                                                                                    |
|------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------|
| ↓                                                                                              | ↓                                                                                   | ↓                                                                                        | ↓                                                                                                     | ↑                                                                                                  |
| <b>S&amp;P/TSX</b><br>11,826.44<br>-39.32<br>Energy stocks lead first decline in four sessions | <b>DJ Ind.</b><br>11,069.06<br>-46.26<br>Interest rate worries undermine blue chips | <b>Nasdaq</b><br>2,262.96<br>-19.40<br>Chip stocks drop as Citigroup cuts recommendation | <b>Dollar</b><br>87.18c (U.S.)<br><b>Unchanged</b><br>Rate concerns in U.S. and Canada squeeze loonie | <b>Gold</b><br>\$556.60 (U.S.)<br><b>+2.00</b><br>Renewed inflation concern underpins bullion gain |

**WISE MENTOR CAPITAL**  
www.WiseMentorCapital.com

**VENTURE CAPITAL**

## 14 First-Date Questions Investors Will Ask



**SEAN WISE**  
WISE WORDS

Last month, investors shared some of the questions they ask entrepreneurs on a "first date" or first meeting with entrepreneurs looking for cash, covering questions, including:

- What is it that you do?
- Why is such needed?
- Who else agrees with you? and
- How much capital do you need?

This month, the so called "First Date" questions turn more specific as investors begin to explore the opportunity more fully.

**What are you going to do with my cash?**

A tangent of "How much do you need?" which deals with the total capital required to hit the next milestone is often "What are you going to do with it?"

While the former question is macro in nature and focuses on the milestones of development, the latter question is micro, in that it tests an entrepreneur's understanding of their business.

Investors want to know that there is a thought out "spend plan" for their investment. They seek comfort in entrepreneurs that have thought through the deployment of each dollar and to an extent, investors must agree with the entrepreneur's spending blueprint. Like valuation, which will be discussed below, this is not a question of being right or wrong, but one of reasonableness.

Five years after the investors have offered their money, they are not going to care if you bought 5 servers instead of 4, hired 10 sales staff instead of 12, or paid \$25/ft for office space instead of \$22. After all, it is impractical to predict such outcomes.

**However, what investors will want to check is threefold:**

- Do I agree with the overall deployment weighting (i.e. % into R/D vs. % into Sales vs. % in infrastructure, etc.)?
- Are the figures well researched and realistic (i.e. has it been priced properly)?

- Is there enough cash to hit the milestones, (as discussed above)?

Typically entrepreneurs underestimate the costs and this concerns investors, not just because it shows a lack of domain knowledge and business acumen, but because it might leave the company short of cash and in turn short of hitting a key milestone.

"It used to be that business plans contained a brief chart regarding use of proceeds. According to Warren Bergen, Executive Director of the Alberta Deal Generator, whose group has looked at hundreds of deals to invest in: "The three lines would generally split the gross amount of the funding between areas like R&D, working capital and marketing. That certainly does not cut it any more. Entrepreneurs that are properly prepared to speak with the finance community will arrive with a detailed finance plan."

**How much is it worth (i.e. what's your valuation)?**

The answer is not an easy one, but at its core, it relies on both intrinsic and extrinsic factors.

Intrinsically, you can judge value based on revenue traction, money invested into the venture to date and intellectual property created to date. So a company with positive revenue, for instance \$1M in R&D and 5 patents, would be worth more than a pre-revenue company that has only invested sweat equity into the business.

Extrinsic factors can be more complex. These generally refer to items that impact the supply and demand of capital in your region and include, but are not limited to:

- How many other deals is the investor looking at right now?
- What is the quality of those deals?
- How aligned is your opportunity with the investment mandate and methodology?
- What other deals has the investor made recently and how do those deals compare with yours?
- What is the perceived terminal value (i.e. what the VC can sell you for after 5-7 years) of your venture?

As you have no doubt concluded by now, there are a number of indicia which factor into valuation and a great number of them are highly subjective. This is why VCs often refer to valuation, as an art and not a science. "Many entrepreneurs neglect to examine the current market conditions regarding value. Getting a read on comparative deals of recent history, will provide some benchmark data to help validate what investors will pay, which matters significantly more than arithmetic models of measure," says Bergen.

Notwithstanding, valuation is a negotiated item and most investors only ask "what is it worth" or "what per cent do I get for my money," at the initial meeting, not as part of negotiation, but as a sanity check. Investors want to gauge your "reasonableness". After all, if what you are seeking is too far from what they deem reasonable, investors will often simply pass on your pitch, knowing that it will be too hard to reach a middle ground. Worse yet, if what you are seeking is so incongruent with the marketplace, investors may begin to question the prudence of your business judgment. As was previously mentioned, remember that valuation is not

about right or wrong, it is about reasonableness.

**Why you?**

Once you have proven that there is a market for what you want to sell, investors will often turn their attention away from the product and markets and towards you, the founder.

This question is a chance for you to explain why it is that you are uniquely qualified to build your business. According to David Hornik, General Partner of VC firm, August Capital and Professor at Stanford's Graduate School of Business, there are two good answers to this question, either:

1. Here is my background, which makes me uniquely qualified to understand the problem my startup is trying to solve; or
2. Here are the circumstances that have led to me getting overwhelmingly excited about the problem my company is trying to solve.

Hornik says that the one answer he hates is "after a lot of research, I decided that there was a big opportunity to make money in X." According to this early stage software investor "Money flows from passion and expertise, not from market research".

Another reason for the "Why you?" question is risk mitigation. Investors try to evaluate where it is possible to mitigate key risks. Management is of course the largest risk of all. It is possible to change market focus or even upgrade a product, but fixing management is more challenging. Rest assured, there are only a few investors that will offer a term sheet, which does not allow them to change management if need be, but doing so is often a long and painful process.

To preclude management turnover, what do you look for in a managing team?

- **Business Acumen** — the skills needed to manage a high growth venture.
- **Domain Knowledge** — experience in the field the venture is penetrating and a network of contacts in such a field.
- **Operational Experience** — more than just theory, experience executing and a track record of delivering.

In a nutshell, investors want to know that you have the knowledge of, contacts in and a history with the market you are tackling. Do you need all three? No. However, the less you have, the higher the risk and the greater the reward you will have to offer investors, which means a corresponding downward slide on the Traction chart, as presented above.

**What are your goals?**

As discussed, investment is often like a marriage. Hence, it is critical to ensure that the goals of both parties are aligned. Investors want to verify that the entrepreneur's goals are consistent with theirs. If not, there is potential for trouble down the road.

Investors typically want a 10x return on their money at the seed stages, where the risk is greatest and a 5x return on their money when traction is accumulating. If a founder of a pre-revenue start-up is busy offering a 10 per cent

return on the money lent to them, it is unlikely that a deal will be reached.

This often affects valuation, as the investor needs to make sure that she or he owns enough of the company, so when it hits its terminal value (i.e. the imaginary future price at which a company value is maximized and then crystallized through a liquidity event — when the company is sold), their share is large enough to generate a return on the risk they have taken.

Beware however, that most investors are not interested in dividends or supporting businesses for life. They want to invest, facilitate business growth, sell the business, and finally collect a return on their investment. If your business cannot go public or be sold in five to seven years, it might be hard for investors to do this. Discussing potential exits requires more than simply stating, that "we plan to undertake an IPO or M&A transaction after five years." You need to show that potential acquirers are out there and subsequently, fuel the imagination and greed of potential investors, by showing them why these large companies will want to buy you. Convey to the investors that you have given some thought to this, even if it still remains in the far future.

**How did you come up with this?**

This is a chance for the entrepreneurs to shine. It is a chance to tell your story. But you must be careful and understand the true meaning behind this question. The true meaning is to peer inside the motivation of the entrepreneur.

For the most part, investors only want to support those founders that they like and feel that they can work with. If a wonderful deal comes their way, but the founder is too hard to collaborate with or has unrealistic aspirations, investors will often pass. The reason for this is multifold, but generally centres around the fact that a start-up business is hard enough to deal with, independent of founder egos and unreasonable expectations.

Then there is the question of underlying motivation. Steve Abrams, from the BDC venture capital group, explains it like this: "To me the question: 'Why the founder came up with this idea and solution' is more important than we let on. I know, after years in the investment game, that it is a rough road ahead even with funding. So I want to know that founder is passionate about this and in love with what they are doing. I need to know that they are 150 per cent committed to the venture and will do whatever it will take to make the business succeed."

**What stops me from taking it to China?**

Or what stops Microsoft from copying it? This question revolves around barriers to entry. If you were able to build your product for under \$100K, what prevents others from doing the same? And if others decide to replicate it, what happens to our investment?

In today's business world, anything can be copied, reverse engineered and knocked off. That is why patents and other forms of IP are important. But IP is not enough; you have to show that your advantage is greater than just a legal right to sue those who copy you. You must show that it will be easier for a big player (ex. Microsoft), to buy your venture, as opposed to building a competitive

product. In that way you can kill two birds with one stone; show that you have a competitive advantage and map out possible exit strategies.

**How big is this market? How big can you get?**

Investors know that, at best your venture is likely to only get a small percentage of market shares. To that end, they want to make sure that this small per cent is on a very large market number. August Capital's David Hornik describes markets in the following manner "We measure market size in two flavours -- really, really big markets and everything else. We are only interested in funding companies that compete in really, really big markets."

Investors tend to risk their money on ventures that are tackling billion dollar sized markets. If however, you are not tackling such, then you need to show that you will easily be able to acquire a much larger market share. Either way, market share is directly correlated with revenue growth and revenue growth is directly linked to terminal value, which in turn affects the return on an investment and that is all most investors want to know.

If however, your business will plateau at a few million dollars in revenue, it may be difficult for investors to support you. Investors often call such businesses "hobby" or "lifestyle" businesses and while there is nothing wrong with such per se, they are generally not fundable.

Why? Well say an investor gives you \$500,000 for your pre-revenue business and takes back 40 per cent equity, after five years, the investor will want to receive \$3-5M in returns. If the business is only doing a million in sales, how will it be sold at \$10M, to generate \$4M in rewards for investors? Terminal values are most often linked to multiples of revenue and a 10x revenue multiple seems pretty steep for a small business. There are of course exceptions that disprove the rule, for example, pre-revenue start-ups sold for multiples that approach infinity, but these are of course exceptions and should not be relied upon.

**How do you scale?**

Scalability means, as your product roll out, your revenues accelerate quicker than your costs accumulate. Take software for instance, the most scalable type of business, once you have done the coding, each sale only costs you the price of burning a CD, even less if you allow for on-line downloads. Whereas in the case of professional services, the least scalable business, your costs are directly linked to your revenue generators (i.e. the people who work there), making it hard to scale.

A business that cannot be scaled will be stagnant in long-term growth and this is not attractive to investors. Investors want to know how their money, which will go to cover costs, will lead to exponential revenue growth. Generally, they are not interested in spending a dollar to make a dollar; they want to spend a dollar to make \$10 in time.

But investors need to know that it is more than just a pipe dream. According to Warren Bergen: "Most entrepreneurs speak only in terms of their percentage of market share gained over time without any detailed plan of how to accomplish this

task." A few questions about how growth will be achieved provides insight with respect to how well developed their strategy is. If an entrepreneur can slap down a comprehensive implementation plan, I know I'm speaking with a more sophisticated entrepreneur. If they are at all vague over the "how" this is all going to grow, it's a dead issue, and my Angels are out."

**What's your Skin in the Game?**

Nothing frustrates investors more, than when they are asked to invest in a company, when the founders have not made the same level of commitment. According to Steve Abrams, from BDC's Montreal office, "The chances of getting funded go down dramatically if the founders aren't fully committed. If the founders aren't committed 100 per cent, I sometimes want to say to them "Don't quit your day job."

Most venture capitalists require the entrepreneur to have a significant portion of their personal net worth tied up in the deal. The reason, according to Bergen is "If the entrepreneur does not have enough in the deal, Investors become concerned that when times get tough it will be too easy for the individual or team to walk away, leaving the VC to come in and clean up and that is not something they want to be stuck doing."

The term "skin in the game," refers to what founders have at risk. The amount of skin in the game is completely subjective and deals with the personal situations of the founders. For some, it might be a mortgage on the house or maxed out credit cards. While for others, it might be the refusal of other employment opportunities or years of hard work. Regardless of their situation, investors need to know that when the going gets tough — you will not get going. They need to know that you have a compelling reason to stay in the course and ensure that their money is well looked after.

**The Bottom Line:**

If securing an investment is equivalent to getting married, then the initial pitch is equivalent to the first date. And like most first dates, making a good impression is vital. So whether you are pitching on reality TV or to a VC, make sure you prepare answers to these common questions, in order to increase your chances of getting a second date.

Sean Wise, BA, LLB, MBA is the Managing Director of Wise Mentor Capital, a national venture capital consultancy focusing on bridging the gap between entrepreneurs and capital. He is the on-line host of the CBC's new venture capital reality show **Dragons' Den**.

Sean is a former Director with Ernst & Young's Venture Capital Advisory Group for Canada, and currently sits on the Boards of the Canadian Venture Forum, the Banff Venture Forum, the Toronto Venture Group and Silicon Valley's IBDNetwork as well as a number of high growth companies in the public and private sectors.

You can read his blog and listen to his podcasts at [www.SeanWise.com](http://www.SeanWise.com).