Financials

- Pro forma financial projections must support and be supported by the business (money-making) proposition.
- Hint: You can't "fill in" this part of the plan with a generic spreadsheet model you downloaded from the Internet.

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- The thing is: investors *assume* your pro forma will be wrong!

About Your Pro Forma…

- “It will take twice as long and cost twice as much as you say it will.”
- “The difference between a venture capitalist and a vulture capitalist is how well or poorly <u>you</u> execute <u>your</u> business model.”
- Projecting into the future is hard; offering a real budget is <u>essential</u>.
- If you can’t <u>accurately</u> explain your fiscal year spending plan, and hold yourself and your company to that budget, you have no cause to be raising capital.

Simple Exercise:

- You say you're going to grow sales next year from $100K to $1MM gross revenue = $900K increase.
- Your pro forma indicates a 40% gross margin. (Revenue – COGS / Revenue).
- You need $540K for COGS to grow sales by $900K.
- Your SG&A must increase to support the increased sales. Add $180K.
- $540K + $180K = $720K / 365 days = need $1,973 more per day than now.
- 90 day receivables turn = $1,973 x 90 = $177,570 to cover the "float" (avoid bankruptcy).
- $720,000 + $177,500 = $897,500 needed + 10% "cushion" = $987,250 needed in order to grow sales by $900,000!!!
- Look again at your budget. If you can't cut costs and expand margins**, you don't have an investible business**. (Relying on organic growth in current year is too risky for most investors.)

Simple Exercise:

- Let's say you cut a bit of "fat" and increased your net margin from previous 20% to 30%. You now need $630K to grow revenue by $900K.
- $630K / 365 days = need $1,726 more per day than now.
- 90 day receivables turn = $1,973 x 90 = $155,342 to cover the "float."
- $630,000 + $155,342 = $785,342 needed + no "cushion."
- Average Enterprise Value (EV) / Sales ratio in your industry is 5.00.
- $1,000,000 projected sales justify a $5,000,000 valuation <u>next year</u>; a $500K valuation this year. Add ~$500K for your business plan and IP = $1,000,000 present (pre-money) valuation.
- $785,342 / $1,000,000 = 78.5%

Simple Exercise:

- Forget the $1B “unicorn” valuation. You’ll argue to give up ~15% of your company ($785K / $5MM) based on “the size of the opportunity” and your investor starts out asking for 78.5% based on industry data and your financials.
- Your ability to negotiate an investor closer to your number will be based on how convincing your business plan is with respect to 12-24 month projections.
- **If your plan isn’t convincing, your company isn’t investible**.

- (Data: http://pages.stern.nyu.edu/~adamodar/)

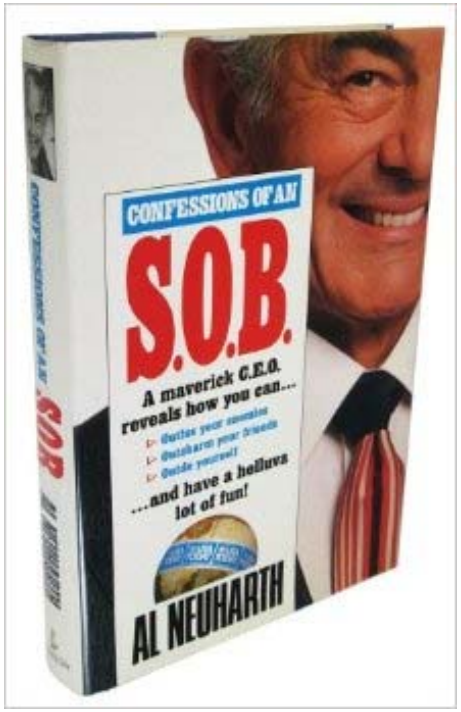
Some Words About Teams

Track, Horse, and Jockey

Complete Management Team?

Three people needed to start a company:

- Someone who understands the technology;
- Someone who can <u>sell;</u>
- Someone who can operate a business.



Why an S.O.B?

- Every ship needs a true captain.
- Captaincy isn’t something that can be delegated away.
- Investors expect the captain to lead from the front, and need to know that the entrepreneurial team will follow her or him.

Geek Out

- Avoid “tag-team” pitching.
- If the CEO doesn’t understand the technology…it shows (not in a good way).
- Outsourcing technical development prior to achieving commercial prototype is risky. Mercenary technologists run out with the $.

Coffee is for Closers

- Least favorite word: “salesandmarketing”.
- The CEO’s #1 job is to sell—to investors and to early customers. Must be able to sell the vision.
- Money spent on marketing that isn’t measurable is money wasted. Marketing doesn’t make sales.
- Selling makes sales. Selling is a process. We want to see your plan and your success metrics.

Sharp Pencil; Green Eye Shade

- Business is a financial activity.
- Again: Business is a <u>financial</u> activity.
- 99% of startups don't need a CFO.
- 99.9% of startups don't need an MBA.
- 100% of startups need a cash-conscious, penny-pinching, budget-hawk. (Experience earned working in a profitable small or family business is a <u>big</u> plus to our way of thinking.)

Once more into the breach

(Now you're in Due Diligence, whether or not the investor says so.)

Let’s Revisit the Simple Exercise:

- Average Enterprise Value (EV) / Sales ratio in your industry is 5.00.
- $1,000,000 projected sales justify a $5,000,000 valuation next year; a $500K valuation this year. Add ~$500K for your business plan and IP = $1,000,000 present (pre-money) valuation.
- $785,342 / $1,000,000 = 78.5%.
- Question: How can entrepreneurs get funded given these numbers?
- Answer: It’s VERY hard. Especially for a manufacturing startup with high capital expenditure requirements at the start. (Which is why American investors tend to fund software startups with low capex.)

Venture or Vulture Capitalist?

- You are telling investors (in the example) that in 3 years, your company will go from losing $7.65 million to earning $78.8 million in profit.
- You are asking investors to value your company on that promise, not on current revenue.
- IF your business plan is sound, and they accept your proposal, how will they value your business based on forward-looking financials?
- Answer: By analysis as they did when reviewing your budget.

More Simple Exercise:

- You are telling investors (in the example) that in 3 years, your company will earn $78.8 million in profit.
- Let's say the average EV/EBIT ratio in your industry is 20.6.
- $78.8 million profit x 20.6 = $1.6 billion liquidation (exit) value.
- Let's say the average EV/Sales ratio in your industry is 5.00.
- $216.3 million sales x 5.00 = $1.08 billion liquidation value.
- Investors say: "Let us suppose—based on *your* numbers—that your company should be worth at least one billion dollars in three years…

More Simple Exercise:

- You REALLY like the idea of a $ billion exit.
- In this example you intend to raise $785,342—call it $800,000 for good measure. $800,000 / .0008 = $1 billion.
- Which means that if the company sells for $1B, all an investor needs to own is .08% of the equity to recover their investment. And if they are looking for a 10x cash-on-cash return on investment (ROI), they'd need to own .08 x 10 = 0.8% at the exit.
- Because angel investors expect to be diluted through 3-4 successive rounds of capital, they'll need 4 x 0.8% = 3.2% ownership at the time of first investment to be left with 0.8% at the exit.

More Simple Exercise:

- You ask investors for $800,000 now, and offer 3.2% equity in your company in return. Which values the business at $25 million.
- You are shocked when investors counter by reversing the numbers: $800,000 for 25% = $3.2 million valuation. Firm offer.
- What you weren't factoring in—but the investors were—was a risk premium. Simply put, they were betting at ~1:8 odds against your business meeting it's pro forma projections, and they demanded to be compensated for that risk.
- Why such low odds given for success? Fewer than 1 in 8 deals succeed. Investors approach every deal with extreme skepticism!

Why Don’t Investors Believe?

- Do they perceive yours to be an “old deal”? Perhaps yours is a company that’s been around for a while but not gained traction?

Why Don’t Investors Believe?

- Do you exaggerate the size of the opportunity? Perhaps your were not careful in describing the <u>addressable</u> (not total) market?

Why Don’t Investors Believe?

- Does your company have a track record of raising capital but not growing value for investors? Is the money raised being spent on R&D or overhead not growth?

Why Don’t Investors Believe?

- Is the company’s balance sheet a concern? Investors won’t put in new money to pay off old debt. Will they demand a cram-down?
- NO off-balance sheet liabilities allowed!
- Founder’s debt should be pari passu with investors.
- Series A and B investors typically don’t like to see >$500K in debt (including convertibles) on a balance sheet unless <u>justified by strong sales</u>.

Things you should know

- Seeking capital is an endless pursuit of credibility
- Investors speak proforma
- Be upfront about your risks and mitigation strategies!
- Expect to spend 3 – 6 months raising a round of capital
- Pitch 15 investors to get one to close.
- Small world; don’t talk out of turn!

Active investors

- Angels have learned we must be involved to be successful
- No more spray and pray
- Distant investors depend on local investors!
- Investors are joining your team
- Treat them as team members!
- Investors want the good, bad, and ugly
- Investors can’t help if they don’t know of your problems
- If you don’t like that, don’t take their money!