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.
• 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 you execute your business model.”
• Projecting into the future is hard; offering a real budget is essential.
• If you can’t accurately 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 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%
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 sell;
• 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 financial 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 big 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 $1 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 you were not careful in describing the addressable (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 justified by strong sales.
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!