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# Chapter 1

## Why investors don't want to invest in your deal!

*By Frank Demmler*

Note: I've known and worked with Steve Czetli for 20 years. I am an admirer of TechyVent as an important and respected communications vehicle to the entrepreneurial/high technology/funding communities. In a recent conversation, he and I agreed that fund raising remains a largely mysterious process for first-time entrepreneurs and angel investors. We thought readers would benefit from a regular column with the goal of showing how capital gets raised in the real world.

I hope to explain how entrepreneurs and investors go through the courtship and mating process, shedding a little light on important aspects and dispelling some myths along the way.

After 20 years of working with early stage businesses, from both the company and investor sides, it never ceases to amaze me how many myths and misperceptions exist about raising capital among first-time entrepreneurs.

One of the most common mistakes is the entrepreneur's belief that raising money for a venture is a linear process with defined steps, and if he takes each of those steps, he deserves to be funded.

Let's get things straight from the get-go – investors never have to invest in a deal (other than as follow on investments to their existing deals that require investment if certain milestones are met, but that's a whole other can of worms, and happens after initial investments have been made.)

In fact, most investors who look at an entrepreneur's deal look for a reason to say, "No." They look for a flaw, any flaw, so they can place the plan in the circular file and move on. Why is this? Aren't they in the business of investing? Why would they want to reject a "great" plan?

Look at it from their perspective. If they're sophisticated investors who have done many deals, *some have failed miserably*. Being professionals, they know statistics like the fact that 80% of all new businesses don't exist after five years. They know that typical venture capitalists only invest in 0.5% – 2.0% of the deals they see (and still with that level of screening, well over half of venture capital-backed companies fail, or do not provide a path to liquidity).

These investors probably have stacks of 25 "great" business plans sitting on their desks or in their briefcases. The goal of their initial screenings is to weed out as many of those plans as possible. A more-or-less constant inflow of new plans seems to keep their stacks at 25 regardless of how quickly the current plans are processed.

This raises another important point that the first-time entrepreneur must understand. Investors know that there's always another deal coming. They can pass and pass and pass on deals, and there will always be another one to invest in. Occasionally, one of those plans won't be rejected, and maybe they'll do that deal.

Being active investors, they know that they will "miss" some good deals. That comes with the territory. They may learn something by revisiting why they rejected the



deals and what the companies did to overcome their concerns, but they don't dwell on that. They mostly focus only on how the deals they did do have fared.

So much for the investing mindset.

### **The language of rejection**

A not-so-obvious, but critical element of fund raising is understanding the communication that goes on between an entrepreneur and a potential investor. The preceding has painted a bleak picture of the nasty investor dashing the dreams of entrepreneurs on a daily basis. Yet, few entrepreneurs would characterize their experience with investors so harshly.

Does that negate all of the preceding? Absolutely not. Investors often come to "No" conclusions, but rarely phrase it that way to the entrepreneur. The following phrases all mean, "No."

- "Your opportunity does not meet our investment criteria."
- "Our plate is really full right now, so we can't devote the time to your plan that it deserves."
- "We might be interested in co-investing when you get a lead investor."
- "We might be interested once you've made a sale to a big company."

Translated, read these responses as: "We are not inclined to want to do your deal, and we don't think that you've got 'a snowball's chance in hell' of [getting a lead investor or closing a major sale.] But just in case you do, we want to leave the door open. After all, maybe we missed something."

Also, if they flat out say, "No," the entrepreneurs may push for explanations that will lead to time-consuming, and probably unpleasant, confrontations. Meanwhile, their backlog of plans is piling up.

With all of this said, deals do get done. Entrepreneurs do attract value-added investors. Great outcomes are achieved. In future chapters, we'll take a look at the dynamics that create these winners.



## Chapter 2

### The Arithmetic of Deals (A)

*By Frank Demmler*

Let's start with a few basics about how corporations work from a structure perspective, and the mechanics of investments. [Note: the same concepts apply to LLCs, but the vocabulary is different.]

When you form your company, you will issue the initial shares of stock to the founding team. For the sake of simplicity, let's say that you are the sole founder and you issue 400,000 shares of common stock to yourself. [Note: the number of initial shares is essentially arbitrary, but it establishes a baseline from which lots of future actions will be calculated, as you will see later in this article.]

Upon launch, the capitalization table would look like this:

	\$	\$/sh.	Shares	%
Founder			400,000	100.0%
Total			400,000	100.0%

There are no values provided for the dollar entries, because there are none. The division of the founder pie is established based upon the overall contributions and value (past, current and future) of the founding team. While the cash contributed and wages foregone will enter into this process, many other elements need to be considered. The net is that the founder pie does not have a specific value that can be stated in dollars. As we learned in last week's column, the value can be whatever the founder(s) wants to say it is.

In this case, since you're the only member of the founding team, you own 100% of the company. With this as a starting point, it is important for you to understand that *investors will buy new shares from the company*, not from the founder. Once the corporation is established, it is a separate legal entity. *Once you have sold shares to an outsider, it is no longer "your company."* It is the shareholder's company.

Let's take a look at how this plays out in an investment.

#### ***Scenario 1: Invest \$600,000 for 60% of the company***

First, we need to establish a definition:

$$\text{Pre-financing Value} + \text{Investment} = \text{Post-financing Value}$$

Therefore, in the given example, in order to determine the pre- and post- financing values, some simple algebra will yield the following information:

If a person invests \$600,000 for 60% of the company, then the founder's equity would be 40%. Since 400,000 shares represent 40% of the company, we can use division to determine that the company has a total of 1,000,000 shares.



	\$	\$/sh.	Shares	%
Founder			400,000	40.0%
Investment	\$ 600,000			60.0%
Total			1,000,000	100.0%

	\$	\$/sh.	Shares	%
Founder			400,000	40.0%
Investment	\$ 600,000	\$1.00	600,000	60.0%
Total	\$ 600,000		1,000,000	100.0%

With that information we can fill in the blanks, determining that the investor will buy 600,000 shares (1,000,000 – 400,000) for \$1.00 per share (\$600,000 invested divided by 600,000 shares purchased).

On a post-financing basis, the company would be worth \$1,000,000 (1,000,000 shares outstanding multiplied by the transaction share price of \$1.00).

The pre-financing value (the founder's stake) would then be calculated as follows:

$$\text{Post-financing Value} - \text{Investment} = \text{Pre-financing Value}$$

$$\$1,000,000 - \$600,000 = \$400,000$$

So far, so good.

### ***Scenario 2: Same investment, but in two rounds of \$300,000***

Let's take a little quiz. In the previous scenario, an investor offered to buy 60% of a company for \$600,000. How much would he buy for \$300,000?

Since \$300,000 is one-half of \$600,000, you are likely to have answered 30%, one-half of 60%, and you'd be wrong. The answer is almost 43%!

***Deals are negotiated with percentages, but they are structured with shares.***

This appears to be a very simple concept, and it is, but it can be very complex in its application. The results are often counterintuitive. That's why an entrepreneur must recognize that and be very facile at performing the necessary arithmetic.

It is not unusual for an investor to do milestone investing, breaking an investment into more than one piece. This way, it is possible to limit the amount of the investment exposed at one time by tying subsequent portions of the investment to specific accomplishments.

In this scenario, we have broken the investment in half so that there are two rounds of \$300,000 each. At the end of the two rounds, a total of \$600,000 will have been invested for 60% of the equity of the company.

Let's look at the company's capitalization table after the first \$300,000 investment has been made.



	\$	\$/sh.	Shares	%
Founder			400,000	57.1%
Investment 1	\$ 300,000	\$1.00	300,000	42.9%
Subtotal	\$ 300,000		300,000	42.9%
Total	\$ 300,000		700,000	100.0%

Contrary to the intuition that might tell you that half of the investment amount should buy half of the equity position of the full investment, the arithmetic works out differently. \$300,000 at \$1 per share purchased 300,000 shares that represent 42.9% of the equity of the company, not 30%.

How can this be?

When an investor purchases equity from a company, he is purchasing shares and, therefore, the share base of the company increases. In our example, before financing, the founder owned 400,000 shares, which represented 100% of the outstanding equity. On completion of a round of \$300,000, the total outstanding shares of the company increased from 400,000 shares to 700,000 shares, thereby yielding an equity position for the investor of 42.9% of the equity at that time.

	\$	\$/sh.	Shares	%
Founder			400,000	40.0%
Investment 1	\$ 300,000	\$1.00	300,000	30.0%
Investment 2	\$ 300,000	\$1.00	300,000	30.0%
Subtotal	\$ 600,000		600,000	60.0%
Total	\$ 600,000		1,000,000	100.0%

Then, if the funding is completed as scheduled, an additional \$300,000 buys the investor an additional 300,000 shares that are also added to the share base of the company. At the completion of this financing, 1 million shares of the company are outstanding, of which the investor owns 60% or 600,000 shares, just like in the first scenario.

### ***Advice to the entrepreneur***

Learning how to do the Arithmetic of Deals is critical for all entrepreneurs.

- Remember: Investors are buying new shares from the company.
- Remember: When someone in addition to you owns shares in your company, it is no long “your company.”
- Remember: Deals are negotiated with percentages, but they are structured with shares.
- Open up your spreadsheet and try a few different scenarios for your company.



## Chapter 3

### Arithmetic of Deals (B)

*By Frank Demmler*

It is essential for an entrepreneur to know how to build a capitalization table and look at any deal in the context of the number of shares of stock that are involved under what circumstance.

***Deals are negotiated with percentages, but they are structured with shares.***

This article discusses the impact of stock options on the arithmetic of deals.

### Stock Options

In the world of private equity investments, stock options are like motherhood and apple pie. Everybody agrees that they're a good thing.

Stock options are rights to buy shares of common stock of the company at some time in the future at a price determined at the time of option grant. For example, let's look at the case of someone being granted options to purchase 100,000 shares of common stock with an exercise price of \$0.10 per share. If that company were to go public at \$15 per share, that person would be able to acquire \$1,500,000 worth of common stock for \$10,000! Is this a great country, or what?

Stock options are a necessary portion of the compensation for individuals who join early stage companies. Investors understand that. Entrepreneurs understand that. There's no argument there. Usually, an early stage business does not have all of the management talent that it will need to be successful. Stock options will be used to entice individuals to join the team.

### The Arithmetic of Deals (part 2)

Let's look at the situation where a founder owned 400,000 shares of common stock and was offered the following deal:

A person invests \$600,000 for 60% of the company. The founder's equity would be 40%. Since 400,000 shares represent 40% of the company, we can use division to determine that the company has a total of 1,000,000 shares.

	\$	\$/sh.	Shares	%
Founder			400,000	40.0%
Investment	\$ 600,000			60.0%
Total			1,000,000	100.0%

With that information we can fill in the blanks, determining that the investor will buy 600,000 shares (1,000,000 – 400,000) for \$1.00 per share (\$600,000 invested divided by 600,000 shares purchased).



	\$	\$/sh.	Shares	%
Founder			400,000	40.0%
Investment	\$ 600,000	\$1.00	600,000	60.0%
Total	\$ 600,000		1,000,000	100.0%

On a post-financing basis, the company would be worth \$1,000,000 (1,000,000 shares outstanding multiplied by the transaction share price of \$1.00).

Let's look at the impact of including stock options in the deal.

So, we have an investor who is willing to invest \$600,000 for 60% of the company. This investor has also let it be known that he believes that there needs to be a stock option pool of 15%. When these statements are translated into a structured deal, the following capitalization table results:

	\$	\$/sh.	Shares	%
Founder			400,000	25.0%
Option Pool			240,000	15.0%
Subtotal			640,000	40.0%
Investment	\$ 600,000	\$0.625	960,000	60.0%
Total	\$ 600,000		1,600,000	100.0%

This is not what the entrepreneur expected. He thought that he would own 40% of the company, or at worst, slightly less than 40% after a modest adjustment for the stock option pool.

What happened? The tyranny of the arithmetic of deals happened. Do you remember?

***Deals are negotiated with percentages, but they are structured with shares***

From the investor's perspective, his offer was such that he would own 60% ***and*** there would be an option pool of 15% ***after the financing***. That leaves the entrepreneur with 25%. If his 400,000 shares represent 25%, then the total shares would be 1,600,000 and all the numbers can be calculated using multiplication and division. Simple arithmetic. Most likely the entrepreneur had anticipated that the investment of \$600,000 would have happened first and then the 15% option pool would be set up. If he had run the numbers, he was expecting to receive something like the following:

	\$	\$/sh.	Shares	%
Founder			400,000	34.0%
Option Pool			176,471	15.0%
Subtotal			576,471	49.0%
Investment	\$ 600,000	\$1.000	600,000	51.0%
Total	\$ 600,000		1,176,471	100.0%

What has been the real impact of these differing interpretations? Since both sides agree that stock options are necessary, that's not the real issue. Whether the initial pool is 240,000 options or 176,471, while not inconsequential, is beside the point because as the options are granted and the team is built, if additional options are needed, they will be approved at that time.

So, when are stock options not stock options? When they're used to mask the actual pre-financing value of an investment. In this example, the apparent pre-financing value was reduced from \$400,000 to \$250,000 by including the stock option pool in the calculation.



While the preceding casts the investor in a negative light, that is not the case. An entrepreneur must be well versed in deal making (and the arithmetic of deals) when conducting discussions with potential investors. Otherwise, entrepreneurial disappointment is highly likely.

**Advice to the entrepreneur**

Learning how to do the Arithmetic of Deals is critical for all entrepreneurs.

- Remember: Deals are negotiated with percentages, but they are structured with shares.
- Ask questions and make sure you understand what a potential investor is saying.
- Do not agree verbally to any individual deal elements.
- Ask for a written term sheet so that you can evaluate the entire proposed investment before commenting to any of its individual features.



## Chapter 4

### Valuation (A): What is your company worth?

*By Frank Demmler*

The response to this question is: Who's asking? Why?

If you're talking to a bank and looking for a loan, your company is worth its book value with some adjustments. If you're trying to impress your neighbors, it's whatever you want it to be. The truth is that closely held private companies don't have a specific value.

The only time that it has a verifiable, specific value is at the time of an equity transaction. At the moment of the closing of that transaction a specific amount of money is being exchanged for a certain amount and type of equity. A valuation can be calculated. At all other times, any valuation you might use will have a very high degree of subjectivity attached to it.

Of all the issues that arise between investors and entrepreneurs, valuation is probably the one that first-time entrepreneurs are most concerned about. On a scale of 0 to 10, they give valuation an importance level, relative to all other elements of a deal, an 8 or 9. They seem to think that there is a single valuation that is correct and that this number is the result of objective analysis and calculation. Wrong!

First, valuation is a very complex issue and cannot be judged without taking the other features of the proposed transaction into consideration. We will probe those other features in future columns. But to give you some sense as to their importance in my opinion, on that scale of 0 to 10, I would probably put valuation at a 5 or less.

OK, back to valuation.

The textbook approach that many entrepreneurs are taught goes as follows:

- Take the fifth year financial projections from your business plan (you do have a plan, don't you?).
- Determine a price/earnings ratio (P/E) for public companies in your industry, and adjust it for what you think it will be in five years.
- Apply that P/E to your fifth year earnings. That is the potential value of your company in five years, assuming it could go public.
- Discount that number by the Internal Rate of Return (IRR) that potential investors in your company will be seeking (40% would be a good guess). That gives you the theoretical value of your company today.
- Divide the amount of investment by that valuation, and that will be the percent of your company that you will be willing to sell to the investor.

Seems reasonable. Probably is in many respects. But it has little-to-no-bearing on the valuation you will discuss with an investor.

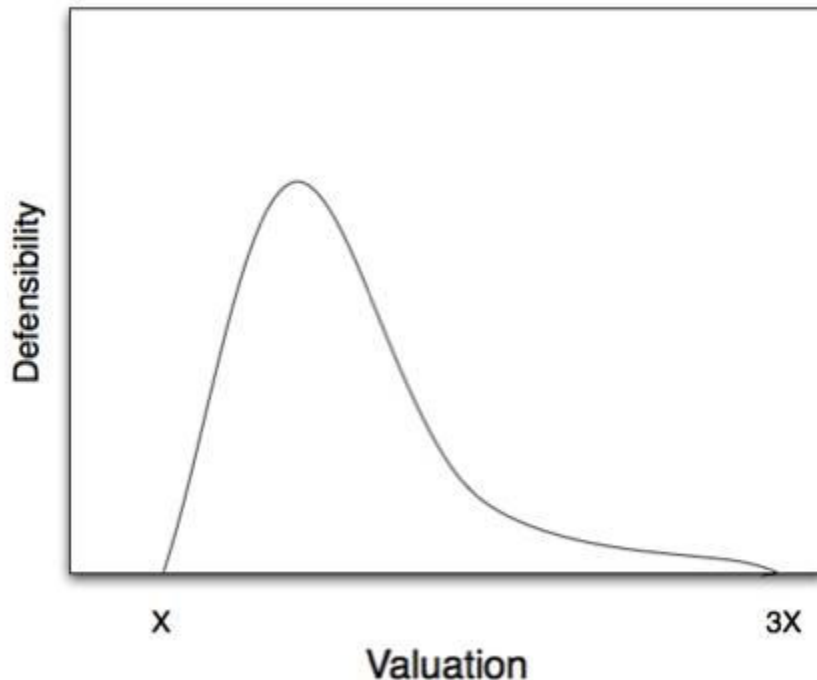
What is your company worth? It's worth whatever someone is willing to pay for it. If that someone is a professional investor, he will be willing to pay some value that is comparable to what other relevant companies have received in relatively recent transactions. In addition, any given investor will also adjust that value to be consistent with other deals that investor has done.



By now, you're probably impatiently thinking, "All right. All right. But what's the answer? What's my company worth?"

Here's my answer. Your company is worth some value within a range. Let me explain.

As you've gathered by now, determining valuation is a largely subjective process. Certainly, crunching numbers on spreadsheets, doing sensitivity analyses, and other quantitative methods are used to calculate different values under different sets of assumptions, but the actual value that an investor will propose is based upon his experience. Valuation is more an art than a science.



In the context of raising money, there's some number below which an entrepreneur would not be willing to accept an investment. Similarly, there's some number above which an investor will walk away. Voila: we've got a range! While not a science, a reasonable estimate of the range is between  $X$  and  $3X$ , where  $X$  is the minimum value you (the entrepreneur) are willing to consider. In today's fund raising environment, the value of  $X$  for a seed investment is likely to be in the range of \$500,000 to \$1,000,000.

See how the curve peaks on the left and trails off to the right? The left scale represents the reasonableness or defensibility of the valuation. The lower the value, the more likely that a reasonable set of variables can be used to justify the value. The higher the value, the greater the risk.

Since investors want to lower risk and maximize the return on investment, the valuation they are likely to propose will be toward the low end of the range. We'll save a discussion of what the entrepreneur can do to try to get higher in the range for a future column.

### **Advice to entrepreneurs**

You need to begin preparing for these discussions TODAY.



- Build a network of mentors and advisors who are active in the deal network. They will have awareness of recent transactions and valuations.
- Build a network of mentors and advisors of entrepreneurs who have “been there and done that,” particularly in your market space. They already have the battle scars. They know how valuations have evolved for their company. They can introduce you to other entrepreneurs in their network. They can introduce you to their investors.
- Do your homework. Subscribe to the newsletters provided by such services as VentureReporter ([venturereporter.net](http://venturereporter.net)), and Venture Wire ([www.venturewire.com](http://www.venturewire.com)), among others. Keep a log of relevant transactions.

As a first-time entrepreneur, you do not need to put yourself at the mercy of the investment community, but it's your job, not theirs, to prepare yourself to engage in valuation discussions when you are seeking capital.



## Chapter 5

### The Term Sheet

*By Frank Demmler*

In past weeks we've looked at why investor's want to say, "No," to your business plan; how they will approach the valuation of your business, if you avoid that, "No;" that deals are negotiated with percents, but they're structured with shares; and that the arithmetic used to quantify a deal can be tricky.

With that as a foundation, we're now ready to take a look at how a deal actually gets done. Probably the most significant step in the process is the receipt of a term sheet from an investor. Today we'll take a look at what the term sheet is.

#### **Definition**

A term sheet is a relatively short document that an investor prepares for presentation to the company in which the investor states the investment that he is willing to make in the company. This document is usually 5-8 pages in length.

#### ***Textbook Definition***

"The term sheet reflects an agreed-on valuation, and sets out the amount of the investment that is to be made, as well as the ownership claims the investor receives in exchange for the investment. In addition, the term sheet may identify some of the options, rights, and responsibilities of each party." (Entrepreneurial Finance, 2<sup>nd</sup> Edition, Smith & Smith, John Wiley & Sons, Inc., 2004)

#### ***Practical Meaning***

While the term sheet is important, and what it contains requires a great deal of study and consideration, perhaps the most important aspect of a term sheet is that it is the first real, dependable indication that the investor is actually interested in investing. Until the preparation and presentation of a term sheet, the investor has likely indicated one, or all of the following, to the entrepreneur when probed about the investor's willingness to invest:

- "It's under review."
- "We're interested."
- "We're doing diligence."

All of these appear to be positive, and the first-time entrepreneur is likely to interpret them as such. At the same time, they don't really say anything, and may really mean, "It's in the stack with all the other business plans that I haven't had time to get to." In other words, talk is cheap, but you need a term sheet to know that the investor is serious. [Note: I hate the word, "interest," in entrepreneurial settings. When an entrepreneur tells me that a customer or investor is "interested," I get very nervous. "Interest" doesn't mean anything in this context. Has the customer issued a purchase order? Has the investor given you a term sheet? Those are meaningful. Interest is not.]

#### **Where It Fits in the Deal Process**

Let's take a look how an investment opportunity may proceed through an investor's process of making deals. The numbers in brackets are my estimates of how many



businesses, out of 100, make it to each succeeding step. By the way, as a practical matter, it is not at unusual for this process to take 8-10 months for the successful firm.

1. Receive & screen business plan [100]
2. Review business plan [20]
3. Bring in management team to present [15]
4. Due diligence [10]
5. Evaluation of opportunity [6]
6. Internal partners meeting [5]
7. Term sheet [3]
8. In-depth due diligence [2]
9. Legal documentation [1]
10. Funding [1]

We'll save the dynamics of this flow and what you can do to improve your chance of making it through all of these steps for a future column. The key thing here for the entrepreneur to appreciate is that the term sheet step is the first one in which the investment firm has decided that it has an intent to invest, if the terms of the deal can be agreed upon.

### **Purpose: Investment of Capital for a Security Interest in the Company**

The first-time entrepreneur may think that the transaction to be completed between the company and investor is a simple exchange of cash for some number of shares of stock in the company. A deal, though, is much more complicated and complex than that. A term sheet is likely to address at least the following:

- Amount of the investment
- Type of security being purchased
- The pre- and post-financing values of the company, including the capitalization table and the role, if any, of an option pool [Note: see last week's column for important considerations about how an option pool can affect how a deal is valued.]
- Definitions and assumptions
- Rights, preferences, privileges, restrictions, and obligations
- Board of Directors
- Representations and warranties
- Negative covenants
- Positive covenants
- Remedial action clauses
- Agreements with the founders and key management

We will look at some of the key provisions in a future column. The key thing here is that the scale and scope of these transactions is very broad and many considerations come into play.

The term sheet is intended to reflect the desires and concerns of the participating parties in a way that is mutually agreed upon. Assuming that it is successfully negotiated, it is then turned over to the attorneys to craft the legal documents. The eight-page term sheet is then converted to 300 or more pages of legalese in at least four legal documents

[Warning: I am not an attorney]:

- Amended and restated articles of incorporation,



- Amended by-laws of the corporation,
- Securities purchase agreement, and
- Shareholders agreement.

**Advice for the Entrepreneur**

- Securing an investment is a complicated and involved process.
  - Don't try to take short cuts.
  - You need to understand what is involved.
- Securing a term sheet from an investor comes after you have passed through a number of key decision points by the potential investor. At each point, the decision is "No" or "Maybe." Your goal is to avoid the "No" and get a "Maybe" at each step along the way, until you get a "Yes" at the last step, and close on your financing.
- Securing a written term sheet from an investor is an extraordinarily important accomplishment in the fund raising process.



## Chapter 6

### An Exchange of Values

*By Frank Demmler*

In the last chapter we took a look at the term sheet and its role in the deal making process. Now we're going to take a look at how the two parties in a deal view the transaction and one another. While I might have been accused of taking poetic license in the past, I plead guilty in advance with regard to the characterizations that follow. The perspectives that I will describe will be closer to caricatures, than reflections of real people dealing with real deals. I am doing this intentionally to make some important points.

As noted last time, the first-time entrepreneur may think that the transaction to be completed between the company and investor is a simple exchange of cash for some number of shares of stock in the company. I then went on to say that deals were really more complicated than that and listed some of the other elements of a deal and their importance.

In this chapter we'll take a step back to see what is really going on with the participants in an investment. An investment is really an exchange of values. What the entrepreneur is "selling" and what the investor is "buying" are actually quite different. The inverse is true as well. What the entrepreneur is "buying" is not the same as what the investor is "selling."

To understand this, let's take a look at how an entrepreneur and an investor may approach a potential deal - their perspectives and expectations. Remember, these are exaggerations, but they do contain kernels of truth, so don't ignore them out of hand.

#### **The Entrepreneur's Perspective**

The first-time entrepreneur often has an emotional bond to his business that is impossible to translate into dollars and cents. It's almost like putting a value on his first-born child. While he knows that he needs capital to grow his business, he is reluctant to put his "baby" in those terms.

##### ***Getting***

"I need to raise some cash to grow my business. When all is said and done, that's what all I need. All the other stuff about 'value-added' services doesn't apply to me. As far as I'm concerned that's just extra baggage that I have to take if I'm going to get an investor's cash. I've heard all about "vulture" capitalists, and I'm not going to let them take advantage of me. I 'know' that my business is worth a lot. The fact that these investors just don't "get it," isn't my problem. They're the ones who are going to be crying the blues when my company hits it big, and they weren't smart enough to invest when I gave them the opportunity.

"Give me your money and get out of my way. Down the road, you'll be very happy that I allowed you to invest in my venture."

##### ***Giving***

"I've put my heart and soul into this business. I've depleted my life savings. I've taken all sorts of abuse from my friends and relatives, but I've persevered and now I've got a



business that is on the cusp of being a phenomenal success. It really rubs me the wrong way when I sit down with an investor and they start talking about how much of ‘MY COMPANY’ they want for their cash! For them to even think that something as common as cash can be equated to my hard-earned effort is insulting.

“Yes, I know I need their money to move to the next level, but that still doesn’t justify the level of importance they subscribe to their cash. After all, it’s only cash for goodness sake and there are lots of places I could go to get it.”

“The investor just doesn’t seem to ‘get it.’ He should be beating down the door to give his money to me. Instead of that, he’s playing hard to get.”

### ***Expectations for the Company’s Performance Moving Forward***

“I have spent an extraordinary amount of time on my business plan and I’m convinced that it’s doable. I’m not so naïve as to think there won’t be any surprises along the way, but I am confident that we have adequate contingency plans to cope with anything that comes our way.

“In fact, I’ve been so conservative in my assumptions, that I am sure that we will out-perform the plan.

“I don’t understand why everyone seems to make such a big deal out of the fact that this is the first time I’ve started a company myself. I’ve been involved with such companies. I’ve studied them in books and magazines. I’ve taken courses and seminars. I’m ready.”

### ***Quality of the Company’s Management***

“My team and I are committed to this venture. Whatever shortcomings we might have in terms of experience, we more than make up for with our intelligence and technical domain expertise.

“When we need to add to the team, I’m sure we can find people. What’s the big deal?”

### ***The Investor’s Role***

“I’ve been warned that the investor will try to stick his nose into places that it doesn’t belong and I will have to guard against that. After all, they’re only money people and can’t possibly be able to bring anything helpful, other than maybe banking relationships, or something like that.

“Also, I refuse to give up control of my company, so if that’s what they’re thinking, they can forget it. That’s a deal breaker for me.

“My fear is that I will have to spend too much time educating the investor about my business.”

### ***Murphy’s Law***

“Murphy said, ‘Whatever can go wrong will go wrong.’ It’s a cute expression, but it doesn’t apply to me. Among my intelligence, the quality of my team, and the quality of our business plan, we won’t be caught off guard. Murphy’s Law only applies to people who aren’t prepared. We are prepared.”

## **The Investor’s Perspective**

The investor’s perspective is a little different, as you might imagine. Remember, these representations are exaggerated, so don’t take [all of] them literally.

### ***Getting***

“When the day is done, I’m looking to make investments that return a lot of money.

While an overstatement, the companies that I evaluate might as well be black boxes. My job is to pick those black boxes that will change a little bit of cash into a lot of cash.



“Many investment professionals specialize in other financial sectors (real estate, bonds, stocks, and the like), and I specialize in early stage companies. Like all professions there’s an art to the business, much of which is only gained through experience. The fact that I am managing the fund that I am is testament to my professional reputation; otherwise I wouldn’t have the confidence of the investors who invested in my fund.

“Early stage companies are an exciting sector in which to participate. The wins can be enormous. By proxy, through my portfolio companies, I have a chance to change the world for the better. With the depth of my experience, I can really contribute to the success of my portfolio companies.

“Ultimately, though, I must believe that this particular ‘black box’ is better, along many dimensions, than the other companies that I could invest in. Fortunately, the flow of deals that I see never ends, so if I don’t do this particular deal, another one will be coming tomorrow.”

### ***Giving***

“My money is only a small piece of what I deliver to my portfolio companies. The fact that I’ve ‘been there, done that’ can help the company avoid mistakes that others have experienced, and take advantage of their successes. It’s rare that a company won’t need follow on funding and my relationships within the venture capital community can facilitate and optimize the terms of such financings. I’ve got many connections within the venture-backed company community and can play a material role in recruiting key employees at the right time.”

### ***Expectations for the Company’s Performance Moving Forward***

“A business plan is out-of-date the moment it’s printed. While I will probe and prod on the business plan, I don’t interpret it literally. It is important for me to see the quality of management’s thinking and how realistic they appear to be. As we discuss the plan, I can judge how ‘coachable’ they seem to be. Nothing’s worse than a management team that thinks it knows it all, particularly if they’ve never done it before. Intellectual arrogance in an early stage business is often fatal.

“My expectations are that the company will move from one crisis to another. I need to judge whether I think it can survive those crises and whether the team can adjust appropriately and quickly enough to continue an upward trajectory for the business, regardless of the hits it takes along the way. If it survives, I expect the business that we will be working with in 24 months will be materially different than the one that is characterized in the plan today.”

### ***Quality of the Company’s Management***

“This is always a difficult issue for me in early stage businesses. I won’t do a deal if I don’t think the team is the right one to launch the business. Further I have to look into my crystal ball and predict the ability of the team to grow as the company’s needs change over time, its ability to recruit quality members in those areas that will need to be filled, and some sense of how tough personnel decisions in the future might be handled without jeopardizing the viability of the venture. I know that industry statistics say that 60% of CEO/founders are no longer with their businesses within 4 years. My experience is consistent with that.

“That said, I’m betting on the jockey, while knowing that the jockey may not be with his company long term.”



***The Investor's Role***

"I don't think it's misplaced ego to say that I can be the difference between success and failure for a company that's fortunate enough to attract me as an investor. My experience and contacts, alone, will be invaluable. My ability to provide mentoring to the founder and his team will help to short circuit their learning curve and help them to avoid making fatal errors."

***Murphy's Law***

"As an investor, I subscribe to Schwartz' Law. Schwartz said, 'Murphy is an optimist.' Time after time, unanticipated events occur that threaten the very viability of a fragile early stage company. Its resiliency to survive those body blows and emerge the stronger for it, often determines the ones that ultimately succeed in a significant way. S\_\_\_ happens."

**Reconciliation**

When one thinks about the different perspectives the parties are bringing to the negotiating table, it's amazing that deals ever get done. But they do. The symbiotic relationship between entrepreneurs and investors in early-stage companies is incredibly dynamic. The term sheet is the first step at recognizing these different perspectives and trying to reconcile them in a mutually agreeable and constructive manner. To the degree that the term sheet and ultimate deal can productively align agendas, the paths to mutual success can be traveled with a minimum of distraction and turmoil. [That's "minimum," not "no." There will be distraction. There will be turmoil. But at least some of it can be avoided.]

**Advice to Entrepreneurs**

- Find out what deals the investor has done previously. Talk to your peers at those companies.
- Make sure that you are "selling" something that that investor is interested in "buying."
- Remember that deals are complex and they are intended to address issues from all parties. Make sure you understand the context within which certain terms are presented.
- Pick your fights carefully. Virtually an infinite number of terms and conditions of a deal could be points for discussion, negotiation, and argument. Some issues are more important than others. Make sure you focus on the most important ones.
- Surround yourself with professionals, mentors, and advisors who can help you level the playing field.



## Chapter 7

### What's so preferable about preferred stock?

*By Frank Demmler*

Once upon a time an aspiring small businessperson needed some money to start his business. Through a circuitous route he found himself in front of the owner of some capital. After explaining his plight, the small businessperson asked the capitalist for a loan. The capitalist replied, "While I find your concept intriguing, there is too much risk associated with it and I couldn't possibly *lend* you the money. If I were to assume this much risk, I would need an *equity stake* that I could sell in the future."

"Well, I would consider selling you some common stock," responded the aspirant.

"That's fine for you, but I need some additional consideration, some kind of preference, in the event you hit less than a home run," observed the moneyman. "After all, I am trying to achieve an appropriate return on my investment, while you are an enterprising young man, an entrepreneur, if I might coin a phrase, trying to change the world."

"You, sir, are a predatory vulture," yelled the youngster.

"I prefer to think of it as being venturesome," countered the investor. "If you want my money, I need to get preferred stock."

And thus the lexicon of early stage business added "entrepreneur," "venture capital," and "preferred stock" to its dictionary.

### Overview of preferred stock

The preceding fiction notwithstanding, preferred stock is the coin of the realm of virtually all institutional, and many private, investors. It is materially different than common stock in many important respects. Some of the terms and characteristics of preferred stock have important characteristics.

#### ***Liquidation***

The conventional definition of liquidation evokes images of "going out of business" signs and sales at heavy discounts. In the industrial world, one thinks of Chapter 7 bankruptcy. In the world of private equity, the definition is expanded to take in virtually any transaction that is agreed to that is less than the proverbial home run. It is tantamount to the investor throwing in the towel on achieving the originally conceived exit, and seeking to "liquidate" his investment.

One of the key features of preferred stock is that higher in the pecking order of who gets paid what and when in the event of a liquidation. Payroll and secured creditors, among others, have first rights to the proceeds of liquidation. Preferred stock holders come next, followed by common stock holders.

#### ***Liquidation Preference (or Amount)***

This is the amount of money the investor in preferred stock has a right to before the common stock shareholders receive any money in liquidation. It is usually phrased in the term sheet something like, "The Preferred Stock Shareholders shall receive all proceeds from the liquidation until they have received 100% of their liquidation preference."

The dollar amount is defined in the term sheet. It often starts with the investment amount plus accrued, but unpaid dividends (often in the range of 6-10%). Then, depending upon



financial market conditions and the types of deals that are being done at the time, some sort of adjustment multiple is defined and applied. These multiples can be

- a single number (1.25 – 2.00 in today's [circa March 2004] market)
- a time-based increment (1.25, increasing by .25 on each anniversary)
- tied to some threshold event (2.00 until the second anniversary, 3.00 thereafter)
- tied to the dollar amount of the liquidation (some formula if the proceeds are less than some amount, and a different formula above that amount)

### ***Participation***

When preferred stock was originally created (see opening paragraph), it was intended to address the differences between the entrepreneur and the financial investor. In essence, if the financial outcome was less than had been anticipated, the investor postured that he wanted the opportunity to some minimum return. What resulted was the creation of simple Convertible Preferred Stock.

### ***Simple Convertible Preferred Stock***

In its infancy, preferred stock was an either-or proposition for the investor. Calculate the liquidation preference, calculate the value of the common stock if converted, and pick the one that is to the investor's greater benefit.

The logic is straightforward and the justification appears to be reasonable.

### ***Participating Convertible Preferred Stock***

After a period of time, someone came up with the idea of Participating Convertible Preferred Stock. Its key feature was that the investor got the liquidation preference first, AND then participated in the distributions on an as-converted basis. The investors justify this on the basis of locking in as good a return as possible in a less-than-desirable outcome. Entrepreneurs often take umbrage at this and consider it to be double dipping. This is a prime example of the Golden Rule: He who has the gold rules. Without negotiating leverage, if the investor seeks participating preferred, then that's likely to be part of their investment style, and it's unlikely that they will be willing to negotiate this feature.

### **Anti-dilution protection**

If the company sells shares at some future date at a share price less than what the investor paid, the investor wants anti-dilution protection.

### ***Full-ratchet anti-dilution protection***

The harshest form of protection from the entrepreneur's perspective is full-ratchet. It says that the investor gets rights to that number of shares as if he had paid the lower price. If he paid \$2.00 per share, and subsequent shares were sold for \$1.00, his number of shares would double to compensate for this transaction.

### ***Weighted-average anti-dilution protection***

Weighted-average is less painful. It takes the share base of the company into consideration, thereby reducing the overall impact. For those of you who are interested, I "borrowed" the following language from the documents one of the deals with which I was involved.

"Adjustment of Conversion Price Upon Issuance of Additional Shares of Common Stock. In the event that at any time or from time to time after the Original Issue Date for any series of Preferred Stock the Corporation shall issue Additional Shares of Common Stock (including, without limitation, Additional Shares of Common Stock deemed to be



issued pursuant to Subsection 2(e)(iii)(1) but excluding Additional Shares of Common Stock deemed to be issued pursuant to Subsection 2(e)(iii)(2), which event is dealt with in Subsection 2(e)(vi)(1)), without consideration or for a consideration per share less than the Conversion Price of such series of Preferred Stock in effect on the date of and immediately prior to such issue, then and in such event, such Conversion Price of such series of Preferred Stock shall be reduced, concurrently with such issue, to a price (calculated to the nearest one tenth of one cent) determined in accordance with the following formula:

$$\text{NCP} = \frac{(P_1)(Q_1) + (P_2)(Q_2)}{Q_1 + Q_2}$$

where:

NCP = New Series A Conversion Price or Series B Conversion Price, as applicable

$P_1$  = Series A Conversion Price or Series B Conversion Price, as applicable, in effect immediately prior to new issue;

$Q_1$  = Number of shares of Common Stock outstanding, or deemed to be outstanding as set forth below, immediately prior to such issue;

$P_2$  = Weighted average price per share received by the Corporation upon such issue;

$Q_2$  = Number of shares of Common Stock issued, or deemed to have been issued, in the subject transaction;

*provided that for the purpose of this Subsection 2(e)(iv), all shares of Common Stock issuable upon conversion of shares of Preferred Stock outstanding immediately prior to such issue shall be deemed to be outstanding, and immediately after any Additional Shares of Common Stock are deemed issued pursuant to Subsection 2(e)(iii), such Additional Shares of Common Stock shall be deemed to be outstanding."*

Got that?

## Control

I often hear entrepreneurs say, "I won't give up control," or "I'm willing to consider any deal as long as I retain 51%." For a plain, vanilla company, that makes sense and is meaningful. But a company that brings in sophisticated private equity is no longer "simple," at least in a legal sense. To a large degree, control and percentage of ownership become separate issues. Let me cite two examples.

## Protective provisions

One of the features of preferred stock will be a series of provisions that require that the preferred stock needs to approve before the company can do certain things. Let me rephrase that, regardless of how much equity the preferred stock shareholders own, they have veto power over certain company actions, typically including, but not limited to, liquidation, alteration of the preferred stock, issuance of any class of preferred stock superior to the existing preferred stock and restrictions on debt that the company can take on.



**Board of Directors**

Similarly, as part of the Preferred Stock transaction there will be agreement to the structure of the board and a Shareholders Agreement will be crafted whereby all shareholders have to vote for members of the board in the proscribed manner, regardless of relative equity positions.

Once a company goes down this path, the issue of “control” becomes complicated and not intuitively obvious, particularly to first-time entrepreneurs.

**Advice to Entrepreneurs**

- If you’re going to play the game, you need to understand the rules.
- Deals are complex. Ignorance is not a defense against unpleasant outcomes.
- Do everything that you can to prevent the investor from invoking the Golden Rule.
- Surround yourself with professionals, mentors, and advisors who can help you level the playing field.

Next week we’ll look at the potential consequences of some of these features of preferred stock.



## Chapter 8

# Is Participating Preferred Stock as Nice as it Sounds? It Depends (Valuation Revisited)

*By Frank Demmler*

Back to the subject at hand, entrepreneurial fund raising. Let's review some of what we've discussed in recent chapters.

### Review of Valuation

In past chapters, I explained that valuation was a number agreed to by the parties involved in a transaction. While quantitative tools are used to estimate, or justify, a range of values, the actual value used in the deal is determined much more subjectively than a first-time entrepreneur would like to believe.

As a starting point, I noted that valuation could be represented by the following equation:

$$\text{Pre-financing value} + \text{investment} = \text{post-financing value.}$$

Further, I cautioned that valuation was just one of many elements of an investment, and that it needed to be put in the context of the total deal. In particular, I said that the terms of preferred stock were material

### Review of preferred stock

Preferred stock is called preferred for a reason. It provides the investor with certain preferences, some of which directly affect the value of his investment under different circumstances.

#### *Features of Preferred Stock*

Preferred stock is materially different than common stock in many important respects. Some of the terms and characteristics of preferred stock can have significant consequences.

### Liquidation

In the world of private equity, the definition of liquidation encompasses most transactions, other than an initial public offering (IPO), through which the investor seeks to "liquidate" his investment.

#### *Liquidation Preference*

One of the key features of preferred stock is that higher in the pecking order of who gets paid what and when in the event of a liquidation. Preferred stock shareholders receive distributions from liquidation before common stock shareholders.

#### *Liquidation Amount*

This is the amount of money the investor in preferred stock has a right to receive before the common stock shareholders receive anything. The dollar amount is defined in the term sheet. It often starts with the investment amount plus accrued, but unpaid dividends. Then some sort of multiplier is usually applied to that amount.

### Participation



Originally, preferred stock was an ‘either-or’ proposition for the investor in the event of liquidation. The investor would calculate the liquidation amount, calculate the value of the common stock if converted, and pick the one that yielded the higher amount. This is called non-participating preferred stock.

The key feature of participating preferred is that the investor gets the liquidation amount first, AND then participates in the distributions on an as-converted basis.

### **Anti-dilution protection**

If the company sells shares at some future date at a share price less than what the investor paid, the investor wants anti-dilution protection, either full-ratchet or weighted-average.

### **Control**

To a large degree, control and percentage of ownership become separate issues in deals including preferred stock

### **How preferred stock terms can affect valuation – a scenario**

Let’s take a look at how all of this can play out.

#### ***The Original Investment***

Let’s say an investor invests \$1 million in your company at a pre-financing value of \$1 million [50-50 ownership]. Let’s also say that the investment purchases Participating Convertible Preferred Stock with a 10% dividend rate and a liquidation amount multiple of two.

#### ***The Sale of The Company***

Two years after the investment, the company has stalled for some reason, and it has never really gotten significant commercial traction and probably never will. An opportunity comes up for the company to be acquired for \$5 million. While not a home run, everyone should be relatively happy. Right? Maybe not.

#### ***The Distribution of the Proceeds***

After two years, the preferred stock purchase price plus accrued dividends has grown to \$1.2 million. After applying the multiplier of two, the liquidation amount is \$2.4 million, which the investor gets “off the top.” The remaining \$2.6 million is divided pro rata with the as-converted shareholdings, or 50-50, meaning \$1.3 million each. The investor has received \$3.7 million and you get \$1.3 million. Under these circumstances, what appeared to be a 50-50 deal at the outset became a 75-25 deal!

### **Advice to Entrepreneurs**

- Valuation is only meaningful in the context of the complete deal.
- Preferred stock provides the investor with extra benefits and rights as compared to the common stock shareholders.
- Understanding the arithmetic of deals is very important.
- Surround yourself with professionals, mentors, and advisors who can help you level the playing field.

Next week we’ll begin to look at the role of angel investors and how you can attract them.



## Chapter 9

### Attracting private investors – 1

*By Frank Demmler*

#### **Private investors**

Thus far in this series of articles, much of the discussion has been focused on institutional investors and their attitudes toward investment in entrepreneurial concerns. On the one hand, this provides some context for you as to how the “professionals” address such investments.

But on the other, the vast majority of companies are funded by private investors. In a “normal” year, venture capital will invest in 2,000-3,000 companies in the United States. Of those, about half will be receiving their first round of institutional investment. This is in contrast with the total of about 14 million businesses in the United States of which well over 13 million have less than 100 employees. Every year, close to one million new businesses are launched. It has been estimated that private investors provide ten times the capital for small businesses as compared to that invested by institutional venture capital. The bottom line for most of the entrepreneurial readers is that your funding is much more likely to come from private sources than from institutional venture capital. For the next few weeks, I will focus on the private investor.

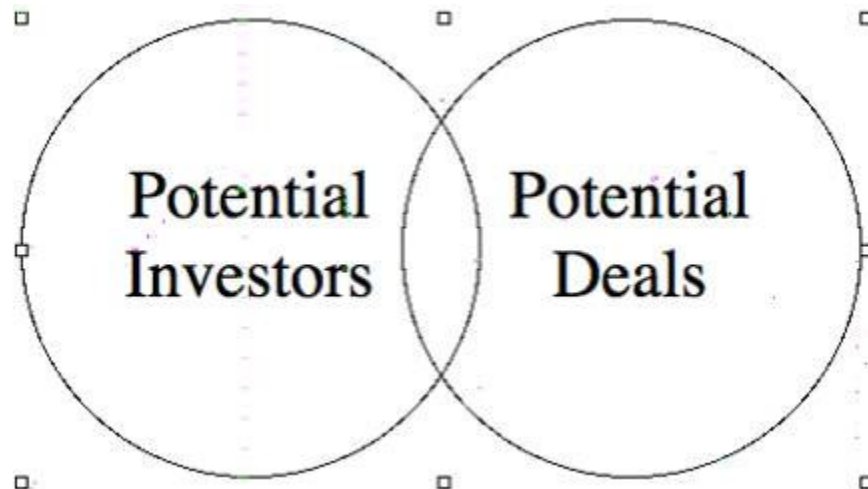
#### ***Not all the same***

Private investors are not all the same. Quite often a first-time entrepreneur gets focused on raising money from an “investor.” This “investor” becomes the sole focus of the entrepreneur as he seeks the “answer” to how to access and successfully solicit funding from that “investor.” If only it were that simple.

The private investor is as varied as your neighbors, as your classmates in the various schools you attended, as the drivers in all the cars fighting the traffic with you each day. Private investors are individuals first and foremost, with the same human differences that each of us has.

As such, some may have an interest in your company and some won't. Some you'll want to be interested in your business and others you'll want to avoid. Some will have investment expectations that you consider to be reasonable, and some won't. Your challenge will be to identify the intersection of potential investors in your company out of the universe of all investors with the deal structures that are acceptable to you out of the universe of potential deal structures.





### ***The Role of PERCEIVED Risk***

The first thing you need to understand as you consider approaching potential investors is that **their perception of the risk** involved with your business (and their potential to receive a return) is the initial hurdle you must overcome. Their perception of risk is likely to be much different than yours. You need to be sensitive to that and responsive to that.

A corollary to this is that this screen is pretty much binary. By that I mean the potential private investor will have an initial reaction to you, your company, and the investment opportunity. If that initial reaction is one of, "it's too risky," you can scratch that person off your potential investor list.

Only if you pass this screen will you have an opportunity to try to convince the individual to invest and to influence the terms under which such an investment would occur.

As you proceed down the path of seeking private investment, the potential investor will be making a series of decisions. The outcome of each decision will be "no," or "maybe." Your goal is to get, "maybe," each time until you finally get the coveted, "YES!"

### **Advice to Entrepreneurs**

- In all probability, your funding is going to come from private investors, not institutional venture capital.
- There is no single "private investor." Each is an individual with his or her own views and sensitivities. Attracting an investment from such sources is not a "one size fits all" proposition.
- The potential investor's **perception of risk** will greatly influence whether he has an interest in investing in your company under any circumstances.
- If you approach a potential investor prematurely or inappropriately, you will lose that investor unnecessarily and for the wrong reasons.
- Surround yourself with professionals, mentors, and advisors who can help you level the playing field.

Next week we'll look at how these issues affect private investors and how you can use this knowledge to improve your chances of successfully raising the desired capital.



## Chapter 10

### Attracting private investors – 2

*By Frank Demmler*

In this chapter we will continue the discussion about private investors. The last chapter's primary takeaway was that there are significant differences among private investors and it is incumbent upon the first-time entrepreneur to understand that, first, and then use it to his advantage to conduct a successful fund raising effort on reasonable terms. Now I will share with you a way to divide potential investors into different categories and how to use those categories in the fund raising process.

#### **PERCEIVED RISK**

Revisiting some of the issues from last week, different classes of outsiders will look at the risk of your enterprise differently.

- A bank will want to see profitable operations, positive cash flow, and sufficient assets to provide collateral for any loan it is going to provide. As such, banks may fund your growth, but they won't fund your start up. According to this method of evaluating risk, your start up is "too risky."
- Alternatively, venture capitalists may not be put off by your company's financial performance to date. In fact, they would probably be surprised if you satisfied any of the bank's criteria. They will want to evaluate the financial return potential of your enterprise and the inherent risk associated with your ability to realize that potential. They will do this evaluation in the context of their experience, their existing portfolio, other deals they are looking at and the investment criteria of the fund. The net of all this will be to come to a decision about the risk-adjusted return expectations of your venture.

These two examples represent the two poles of the financial sources scale. They share the characteristics that they are reasonably predictable with regard to their requirements for your ability to access their capital. The same could be said for other identifiable sources, economic development funds, technology grants, etc. They have stated criteria and an honest evaluation of your firm will help you determine whether you have any chance of qualifying for their funding. Too often, first-time entrepreneurs don't do their homework and/or don't have the sophistication to properly assess their qualifications. This can lead to disappointment, and sometimes anger, that could have been avoided. Entrepreneurs have to gain the sophistication to understand what sources are viable for them and which aren't. The competition for those funds is often quite intense, and the people responsible for making the funding decisions have extreme time pressures placed upon them. You are not doing yourself any favors by aggressively pursuing a source of capital for which you don't qualify. Similarly, creating ill will by venting your frustration when you are inevitably turned down is not smart. Don't shoot the messenger, particularly when the source of the problem is your mistaken belief that these programs are set up for "you" and you are "entitled" to them. You are not entitled to any of these funds. Get over it. Compete for funds for which you are qualified, and compete well and from an informed base.



Private investors are not so predictable. That's why you have to manage the process.

### **Sources of Risk**

The first step in attracting private investment is to recognize how others will react to the risk of your enterprise. While risk can have an almost infinite number of dimensions, there are two core sources of risk: the business and the people.

#### ***Business Risk***

The types of questions that a typical private investor might ask include:

Is there a market opportunity worth pursuing? Is the business at hand a reasonable way to exploit the opportunity? Who are the competitors and how are they addressing the identified opportunity? Can a start up or early stage business realistically establish itself in such circumstances? Who are the customers? How are they accessed? How do they make purchase decisions? Can the venture successfully close sales?

What is the role of technology in this venture? Does the company have proprietary intellectual property? Is the technology invented, or in a lab? Have customers used it and endorsed its value? Can it be effectively protected?

I could go on and on, basically providing a full list of due diligence requirements that an institutional investor will use to evaluate such a deal, but you get the point. Evaluating business risk can be quite daunting for the typical private investor.

#### ***People Risk***

Similarly, the types of questions that a typical private investor might ask about the people include:

Is the venture's team the one that will successfully exploit this opportunity and provide a desired financial return to the investors? Do they have relevant industry experience?

Have they done it before? Can they grow to meet the venture's future needs? Will they accept advice and guidance? Will they attract quality people to the team and let them do their thing? Do they understand the value of a dollar in an entrepreneurial concern?

Are they good people? Do I want them to win? Do I want to work with them? Do I like them? How do I know if they have integrity? How can I go beyond superficial impressions and really get to know them as a person?

### **Evaluating risk**

Just as risk has many dimensions, evaluating that risk can go in many, many directions. In the private investor arena, the potential investor is unlikely to have the resources, time, or motivation to go a "professional" due diligence process. The private investor is rarely making investments in companies such as yours as his primary occupation. If it's "too hard" to evaluate your business, they will pass and move on to the next deal. Remember last week's advice:

- If you approach a potential investor prematurely or inappropriately, you will lose that investor unnecessarily and for the wrong reasons.

This discussion is why I gave that advice.

What are you to do then? How do you influence the perception of risk? For lack a better way to express it, you need to evaluate how well potential investors know the business and know you. If a particular individual knows something about your business, he will either "get it" or not. If he "gets it," then his perception of risk will be significantly reduced relative to someone who doesn't know the business. Similarly, someone who knows you and thinks well of you will perceive lower risk than someone who doesn't.



		<b>THE BUSINESS</b>	
		<b>KNOW</b>	<b>DON'T KNOW</b>
<b>THE PEOPLE</b>	<b>KNOW</b>		
	<b>DON'T KNOW</b>		

### Advice to Entrepreneurs

- Many sources of capital have defined criteria and processes for attempting to access that capital. It is the entrepreneur's job to learn what's what, and to honestly evaluate whether his company qualifies for consideration.
- Private investors are less predictable than institutional investors. The entrepreneur needs to understand and categorize potential private investors according to their perceptions of risk.
  - Do they know anything about the business?
  - Do they know you?
- Surround yourself with professionals, mentors, and advisors who can help you level the playing field.



## Chapter 11

### Private Investors (C): Attracting private investors - 3

*By Frank Demmler*

Over the next few chapters I will provide you with a process that you can employ to plan your fund raising strategy. Many of the companies that have used this process have successfully raised money from private investors. In the last chapter I closed with a way that you should consider classifying potential investors in your business based upon how well they knew you and/or your business.

		<b>THE BUSINESS</b>	
		<b>KNOW</b>	<b>DON'T KNOW</b>
<b>THE PEOPLE</b>	<b>KNOW</b>		
	<b>DON'T KNOW</b>		

This week we'll look at why this is important and how you can use it to your advantage.

#### **PERCEIVED RISK**

Taking a step back, how **OTHERS** perceive risk is the important point, as we've discussed in recent weeks. Let's take a look at the perceived risk of the four categories of potential investors represented by the above table.

#### ***Don't Know You – Don't Know the Business***

Think about it. If a complete stranger contacted you and asked you to invest in a business you didn't understand, what would be your response? Why?

If you were like most normal people, your answer would be something like, "I will not invest in your company because I don't know anything about you or your company, so it appears to be extremely risky. I would have to devote a lot of time and energy to be comfortable to even consider an investment."

Why would people you approach respond any differently?

Without extenuating circumstances (and there are some we'll discuss later), if this group were to be your primary focus of fund raising, the characteristics you might expect would include:

- long decision time
- highest return require, due to the perceived risk
- lengthy due diligence process

At the same time, though, it does represent the largest pool of potential investment.



***Know You – Don't Know the Business***

This group of private investors that Jeffry Timmons noted professor of entrepreneurship and author calls the 3 F's - Family, Friends & Fools. These are the people do not see a lot of risk because they know you and are often willing, or feel obligated, to invest you.

Quite often their motivation for investing has little or nothing to do with financial gain.

Some of the characteristics of this group include:

- quick decision
- lower economic cost
- highest potential psychological cost

The last point is worth commenting upon. The role of 3F investment is often hotly debated. Some investors won't invest unless you've tapped that source. If friends and family don't demonstrate their confidence in you, they'll say, why should they? If you say that you haven't approached them because you don't want them to risk their limited capital in your business, the typical response from an investor will be to challenge your level of confidence in your own business.

These attitudes are next-to-impossible to change. If you are comfortable including friend and family investment, or welcome it, for that matter, then it's not an issue. If you choose not to seek investment from this source, and another investor challenges you on it, thank them for their time and move on. You won't change that investor's mind.

***Don't Know You – Know the Business***

Someone in this category is likely to respond in one of three ways to your business proposal: I don't agree; Ho-hum; or "I get it!" If you get one of the first two responses, thank them for their time and move on. If you get the last response, you have reduced the risk significantly. Now you've only got to convince them that you're the right person to exploit the business opportunity.

Some of the characteristics of this group include:

- moderate decision time
- great anchor & halo effect
- higher return expectations
- can add significant value

If someone from this group were to commit to an investment, their independent endorsement may significantly impact the risk perceptions of others, thereby motivating them to invest. Hence the reference to the anchor (locks in a deal) and halo effect (their participation, alone, impacts others favorably).

***Know You – Know the Business***

Again, the knowledge of the business is a very important distinction for this group. The interpersonal relationship, though, has its own implications. On the one hand, the decision making process may be shorter since both major risk areas are greatly reduced. On the other, the personal relationship may somewhat diminish the halo effect of this investor's participation.

Some of the characteristics of this group include:

- quick decision
- good anchor
- halo effect
- can add value



## Summary

Not all investors are the same. Analyzing their differing characteristics can provide you with insight as to how to approach each type and when. As we will discuss next week, you can, and should, use this knowledge for your benefit in fund raising.

		<b>THE BUSINESS</b>	
		<b>KNOW</b>	<b>DON'T KNOW</b>
<b>THE PEOPLE</b>	<b>KNOW</b>	<ul style="list-style-type: none"> <li>• quick decision</li> <li>• good anchor</li> <li>• halo effect</li> <li>• can add value</li> </ul>	<ul style="list-style-type: none"> <li>• quick decision</li> <li>• lower economic cost</li> <li>• highest potential psychological cost</li> </ul>
	<b>DON'T KNOW</b>	<ul style="list-style-type: none"> <li>• moderate decision time</li> <li>• great anchor</li> <li>• halo effect</li> <li>• higher return expectations</li> <li>• can add significant value</li> </ul>	<ul style="list-style-type: none"> <li>• long decision time</li> <li>• highest return requirement</li> <li>• lengthy due diligence</li> <li>• largest pool of capital</li> </ul>

## Advice to Entrepreneurs

- A potential investor's **perception of risk** will greatly influence whether he has an interest in investing in your company under any circumstances.
- To be able to manage the fund raising process to your greatest advantage, you need to categorize your potential investors by their perception of risk.
- Using their knowledge of you and your business can be a useful method for categorization.
- Surround yourself with professionals, mentors, and advisors who can help you level the playing field.



## Chapter 12

### Private Investors (D) – Tactical Plan for Raising Money From Private Investors

*By Frank Demmler*

The first step in attracting any potential investor is to address the risk of the opportunity, as perceived by the investor. Venture capitalists do this by conducting due diligence, a structured, possibly lengthy and costly, process whereby they attempt to confirm the business proposition and the people who are proposing it.

In the private investor arena, full blown due diligence of this type is rare. Most often, the substitute for due diligence is Affiliation Risk Reduction. In essence, it's a process of getting new investors to commit to an investment because of the investors who have already committed.

The metaphors I can use to illustrate this point are many, so I'll try a few:

- You're known by the company you keep.
- Set up the dominoes so that when you knock one over, the others will fall behind it.

And for the cynics among you,

- Misery loves company.

The key point is that most private investors will never be able to understand your business, or your ability to run it. If they had to make an investment decision in isolation, it would most likely be negative. Recognizing that, your job is to secure a surrogate whose judgment that private investor will be willing to accept as an endorsement to both.

### Sequencing Implications

Last week we closed with a method to categorize potential investors into different groups. This week we'll look at how you can use that insight to favorably impact your fund raising efforts.

		<b>THE BUSINESS</b>	
		<b>KNOW</b>	<b>DON'T KNOW</b>
<b>THE PEOPLE</b>	<b>KNOW</b>	<ul style="list-style-type: none"> <li>• quick decision</li> <li>• good anchor</li> <li>• halo effect</li> <li>• can add value</li> </ul>	<ul style="list-style-type: none"> <li>• quick decision</li> <li>• lower economic cost</li> <li>• highest potential psychological cost</li> </ul>
	<b>DON'T KNOW</b>	<ul style="list-style-type: none"> <li>• moderate decision time</li> <li>• great anchor</li> <li>• halo effect</li> <li>• higher return expectations</li> <li>• can add significant value</li> </ul>	<ul style="list-style-type: none"> <li>• long decision time</li> <li>• highest return requirement</li> <li>• lengthy due diligence</li> <li>• largest pool of capital</li> </ul>



***Don't Know You – Know the Business***

This is the best type of investor you can secure. If someone from this group were to commit to an investment, their independent endorsement will significantly improve the risk perceptions of others. Not only have they put their seal of approval on your business, but they have taken the time to make an independent, unbiased appraisal of you.

***Know You – Know the Business***

This is the second best group, but may be the first one you address. Like the prior group, their endorsement of the business is meaningful, but their personal relationship with you may bring this person's objectivity into question. Still, someone from this group may prove to be an ideal conduit to someone in the first category.

***Know You Well – Don't Know the Business***

This group is not perceived to have independent credibility. They should be actively solicited only after investors in the first two categories are moving in the right direction.

***Don't Know You – Don't Know the Business***

If you do the preceding correctly, this group of investors will be anxious to get in on your "hot" deal.

Think about how this has changed the dynamics! If you went after this group first, as many first-time entrepreneurs do, you would face tremendous resistance and likely rejection. They don't know you. They don't know the business. Your proposal is extremely risky.

With the approach suggested in this column, though, the fact that others with independent credibility have endorsed the deal reduces the perceived risk. The fact that the deal is getting further commitments reduces the risk. The fear that the deal will be fully subscribed, and the investor might be prevented from participating, may induce a quicker decision!

**Tactical plan**

When you decide to launch fund raising, you need to have a game plan plotted out in advance.

**WARNING:** I am not an attorney. Some of what I'm about to write could violate securities laws if not done correctly. Make sure your attorney is aware of what you are doing.

***Prepare to launch your fund raising campaign***

How much money do you hope to raise? What terms are acceptable to you (subject of a future column)? When would you like to close the deal? Are you prepared to devote the necessary time and energy? Have you assembled and prioritized a potential investor list? Have you prepared the necessary collateral that you will need to support your fund raising efforts?

- Business plan (no more than 25 pages, plus appendices)
- Mini-plan (3-to-6 pages that captures the essence of your business)
- Executive summary (2 pages or less that leaves someone wanting to know more)
- One-pager (the elegance of brevity)
- The elevator pitch (the story you can tell a stranger on an elevator when traveling 3 floors that will make the strange want to know more)
- A 22-slide PowerPoint presentation (that can be reduced to 8 slides when necessary, or expanded to 60 when appropriate)



***Begin the process of getting the word out***

Create some positive buzz about your business through formal and informal channels. Perhaps share your one-pager (see above) with selected individuals as an update to what the company has accomplished and where it intends to go. DO NOT solicit any investment interest at this point. That's practical as well as legal advice.

***Get commitments for 15-25% of the total deal from credible investors***

Your goal at this point is to get an investment commitment from 1-to-3 individuals whose credibility is likely to get others to invest. If you were seeking \$500,000 total, you would like to get commitments in the range of \$75,000 - \$125,000 at this stage of the fund raising process.

From your list of potential investors, identify the 10-15 that fall into the two primary categories of people who know the business, whether they know you or not. Of these, who are the 6-10 that it is the collective judgment of you and your advisors that could invest and are likely to respond favorably to your pitch? Determine how you can get to each. If you've done the job right, you're likely to be only 2 introductions away from these people (in the context of Six Degrees of Separation).

***Use that commitment to "knock down a few more dominoes"***

With the core commitment in place, expand your reach to the next circle of potential investors. Up until this point, these people have expressed "interest" in your company and a potential investment, but haven't committed to invest, and really haven't had anything to commit to until this time.

Prudent application of time, energy and pressure, should get the commitments to your deal to the 40-60% level.

***Use momentum to drive to a successful closing***

With the apparent momentum of the deal, and with a closing day in sight, you will have three powerful tools at your disposal by this time. You have a deal, so the fence sitters now have something to look at about which they can make a decision. You have a closing date, so they need to make the decision within that time frame. You have a dwindling amount of investment available, and with a "first come, first served" posture on accepting investment, there is pressure on the potential investor to decide sooner rather than later.

**Advice to Entrepreneurs**

- Categorize potential investors with regard to their perception of risk of an investment in your business.
- Identify less than 10 individuals whose investment commitment will have a favorable impact on the investment decisions of others.
- Create a proactive fund raising game plan that you can execute to your advantage.
- Appreciate the dynamics of the fund raising process and use that to your advantage.
- Surround yourself with professionals, mentors, and advisors who can help you level the playing field.



## Chapter 13

### Deal Structures (A): What's the Deal? – 1

*By Frank Demmler*

In the last chapter we looked at a process by which a first-time entrepreneur can increase the likelihood of successfully attracting money. In it I referenced getting commitments from investors.

“Commitments to what?” you might well ask. A dollar amount, sure. But what is their money buying? What's the deal?

Unlike institutional investors who almost always purchase preferred stock, in the private investor arena, deal structures are only limited by the imaginations of the involved parties, and the legal environment in which they are struck.

#### **Range of Private Investors**

As pointed out in prior columns, private investors are not all the same, and in fact, differ along many dimensions: how well they know you; how well they know the business; how much experience they have investing in early stage companies; how those prior investments have worked out; their net worth; and their risk tolerance, among other characteristics.

As it relates to deal structure, we can define the two extreme poles of return expectations and then look at how deal structures might accommodate these different desires.

At one pole is the risk averse individual who primarily wants to lock in a cash-on-cash return that is better than what he can get from conventional sources, i.e., CDs or money market funds. Losing their principal amount is not something that they want to consider. At the other pole is the gambler. He is willing to lose 100% of his principal, as long as the potential upside is a “home run.” Mixing metaphors, he's willing to roll the dice and hopes he doesn't crap out, but will be philosophical if he does.

Most people fall somewhere in between.

#### **Range of deal structures**

Let's take a look at how all of this can play out.

**Notes with interest:** There have been occasions in which a private investor is willing to lend the company money at some interest rate higher than what the investor is getting elsewhere.

This is rare. Think about it. A bank will lend a company money if it has sustained a record of profitability; if it has the ability to pay the debt service; and if it has sufficient assets the liquidation value of which will collateralize the loan (and, in many circumstances, if you provide a personal guarantee).

The people who will consider this form of investment are likely to be unsophisticated and not fully appreciate the risk involved in investing in early stage businesses, or people who are not investing primarily for financial purposes (friends, family, etc.). A note from a company is a security, and does need to meet securities laws, filings, and reporting requirements.



**Notes with interest and warrants:** One way to address the riskiness of this type of loan is to offer warrants. A warrant is the right to buy stock in a company at a price that is determined today but can be exercised until some time in the future. For example, if the price were set at \$1.00 per share and the company was sold at a later date, the investor could exercise the warrant at the time of the acquisition at \$1.00 per share and get an immediate \$9.00 per share gain.

Unlike a conventional note, this investment structure does involve selling equity, albeit at some future date.

**Convertible notes:** One of the benefits of notes is that if the company were to face an unpleasant ending, notes are higher in the pecking order for repayment in the case of liquidation or some similar event. A convertible note addresses these concerns. It is a note, with stated interest, but it may be converted into stock by the investor based upon some predefined circumstances, such as a following round of equity investment, and on terms that have been negotiated (usually a discount to the price per share of the equity round, or warrant coverage).

Convertible notes are often used if you think there's a compelling reason to avoid placing a valuation on the company at the time of the transaction. For example, if the company has received investment interest from a venture capital firm, but is only willing to proceed when certain accomplishments have been achieved (such as customer acceptance of a product or a patent issued). You will argue to the private investor that putting a value on the company today will establish a lower baseline from which the venture capital firm will establish its value for the next round. By doing a convertible note, you will add, the investor gets into a deal with an almost guaranteed return (the discount or warrants) with very little risk.

Moving along the continuum, this structure is a commitment to sell equity, with many of the terms of the equity predetermined.

**Convertible preferred stock:** We have discussed this in prior weeks in the context of venture capital. This is the sale of equity. The preferred nature of the security has many significant features associated with it; including a preference in receiving proceeds from any exit other than a qualifying initial public offering, and various protective provisions that require investor approval for certain actions by the company.

**Common stock:** This is plain old vanilla stock in the company. Everybody's equal. If the company does well, everybody does well. If it doesn't, everyone suffers equally. That's the way it's presented, at least.

The reality can be much different. If you don't manage the company so that an investor exit is likely, then what? Dividends? Law suits? Disintegration of friendships? [I'm probably being overly dramatic, but as they say, "The road to Hell is paved with good intentions.]"

As the preceding should illustrate, the types of deal structures that can be used with private investors are many. Attitudes about sharing equity, the distribution of risk and reward, and sophistication of the parties involved will impact what deals are acceptable to you, and what types of investors will be willing to participate in such deals.

## **Advice to Entrepreneurs**

- Private investors are a varied group of individuals.
- Deals can be structured to accommodate these differences.



- You need to understand the implications of different structures and select the ones that are acceptable to you.
- Take the results of this exercise and map it into the fund raising process presented last week to launch a successful fund raising campaign.
- Surround yourself with professionals, mentors, and advisors who can help you level the playing field.



## Chapter 14

### Deal Structures (B) – What's the Deal? – 2

*By Frank Demmler*

Last week we looked at a range of investment structures that might be employed with private investors. They fell upon a continuum based upon risk tolerance and desired rates of return for investors, ranging from notes with interest to common stock. This week we'll look at some alternative deal structures that don't really fit in that range, and do reflect last week's observation that deal structures are only limited by the imaginations of the involved parties.

#### **Avoid Giving up Equity**

Many entrepreneurs don't want to give up any equity in their company. Such entrepreneurs often fall into one of two groups.

First-time entrepreneurs rarely look at equity as a bargaining chip that they're willing to bet. They view their equity as sacrosanct and won't give it up for anything as crass as money.

Secondly, sophisticated entrepreneurs who want to build their companies, but don't want to take them to an exit that rewards equity investment (acquisition or IPO) will need to create a reward incentive that can be met through other means.

We'll look at some examples that satisfy these conditions.

#### **Revenue participation certificate**

This is a simple and relatively elegant investment vehicle. It's really a royalty with a fancy name. Its essence says:

**I will pay you X% of revenues until you get Y times your money back.**

This has several appeals.

Revenues are relatively straightforward to measure.

Both sides know how much money is owed; the only variable is timing.

X and Y will be negotiated in the context of your business plan. X will be large enough to provide a reasonable cash flow to the investor and Y will be set based upon perceived risk. Using your business plan as the basis, you will be able to tell the investor this deal will provide him with a particular annual rate of return.

For the investor, this is structured so that the focus of the negotiation is on **when** he will get his return on investment, **not if** he will.

If the company takes longer to grow sales than the plan anticipates, the rate of return will be reduced, but it is still likely to be attractive. For example, if it takes five years to provide the return rather than the three years that was anticipated when the deal was struck, that may mean the annual rate of return might be reduced from 30% to 17%.

The persistence of the payment will be an incentive for you to pay the security off as quickly as possible. You will begin to look at those payments representing money that you could use to grow your business, or put in your own pocket.

This base deal can be modified to accommodate specific circumstances. For example, the parties can agree to delay the commencement of payments until 6 or 12 months after



closing so that the company has some runway to put the investment to work before impacting the company's cash flow.

Beyond the standard legal warning above, while the deal appears to be very simple, it will be a challenge from an accounting and tax basis, so get good professional advice if you go down this road.

### **Put and call**

Another fairly simple structure is for you to sell a security to an investor that has a straightforward put and call. A put is an investor's right to force the company to buy his security upon specified terms; to put the security to the company. A call is the company's right to buy back the investor's security on specified terms; to call the security. A deal using this structure might be phrased:

**The company has a call on the investor's security at X times the investor's investment amount until the third anniversary of the investment. After the third anniversary of the investment the investor may put his security to the company at X+1 times the invested amount.**

Those multiples might be 2 and 3, for example, or 3 and 4, for that matter. The important point here is that you have a finite period of time to pay off your investor before the cost of that money increases significantly. Therefore you will manage your business with that in mind so that you can avoid that. By setting up these rules at the beginning, everyone knows the consequences of their actions.

### **Special situation: unwinding a partnership**

While this is a little off topic, I offer it as another example of imaginative deal making. It is not unusual for two people to start a business and after a period of time realize that their goals are not the same. The worst thing that can happen is for the business to be paralyzed because no decisions can be made. Under these circumstances, a "divorce" is usually the best thing to do, and have one partner buy out the other. What if they can't agree on how to do this? Here's an approach that I have seen used:

- Flip a coin.
- The winner gets to choose whether he goes first or second.
- The first person sets the price for the business.
- The second person gets to decide whether he wants to buy or sell.

Right or wrong, the conundrum gets resolved and each partner can get on with his life, and the business can prosper in the way that the buying partner envisioned.

### **Advice to Entrepreneurs**

- There are ways to raise money without giving up equity.
- Only a subset of potential investors will find such deals of interest.
- Deal structures are only limited by the imaginations and expectations of the participating parties.
- Surround yourself with professionals, mentors, and advisors who can help you level the playing field.



## Chapter 15

# Fund Raising Recap: The Abridged Version of Raising Money from Private Investors

*By Frank Demmler*

### Requirements for a successful closing

There are three requirements for a successful closing on an investment from private investors:

- A deal,
- A closing date, and
- Money committed from private investors.

### The process

It's all about **reducing the perceived risk**.

Consider the **amount of money** you would like to raise:

- The optimal amount, if you could wave a magic wand;
- The practical amount that will allow you to accomplish significant achievements and is likely to be available on reasonable terms;
- The minimum amount that allows you to make some progress; and
- The bootstrap amount that keeps your company alive.

Seek advice and feedback from your business associates and mentors. **Pick a number.**

Compile **lists of potential investors**, probing down the paths of people who know you and people who know the business.

- Your Christmas card list;
- Your Rolodex;
- Those of your close friends and business associates;
- Potential suppliers, their founders, and individuals within them;
- Potential customers, their founders, and individuals within them;
- ☐ Potential channel members, their founders, and individuals within them; and
- Who knows who, who knows someone else, who knows the person you really want to talk to?

Refine the list and **categorize the potential investors** by their level of perceived risk.

Identify that subset of potential investors whose participation in your deal would significantly reduce the perceived risk by others and motivate them to invest as well (**anchor investors**).

Get access to that subset of potential anchor investors and generate **investment desires of at least 15 – 25% of the entire deal** from one-to-three individuals.

Considering the universe of potential deal structures, and the investment interests of the potential anchor investors, propose and negotiate a deal structure with the anchor investors. **THIS SATISFIES THE FIRST NECESSARY CLOSING CONDITION: YOU HAVE A DEAL!**

In parallel, you will have informed other potential investors of the status of your company, all the great things it has done, and all the opportunities that are in front of it.



You will now communicate with those whose investment interest can be converted to commitment by virtue of the anchor investor commitments.

**Pursue this second tier of potential investors until you have received cumulative commitments of 40 – 60%** of the required capital. When you sense positive momentum for the deal, set a closing date for the transaction in about 45 days.

WITH A CLOSING DATE, YOU HAVE NOW SATISFIED THE SECOND CONDITION FOR A SUCCESSFUL INVESTMENT.

You are now in a position to get the next tier of potential investors to commit to your deal. Not only are they aware of the business progress you've made, but they are also aware of the momentum building for the deal. You've got quality anchor investors validating the investment opportunity. You've got additional investors who have also committed. There is a deal that they can look at and evaluate. There is a closing date that forces them to make a decision. And there's the implied threat of not being allowed into the deal if it gets fully subscribed before they make a commitment.

If you are truly an entrepreneur, your deal will be oversubscribed and you will have to decide whether to take more money than you had intended. [The answer is "YES!" almost without exception, but that's a topic for another column.]

THE THIRD CONDITION, INVESTMENT COMMITMENTS, IS MET AND YOU'VE CONCLUDED A SUCCESSFUL ROUND OF PRIVATE INVESTMENT!  
CONGRATULATIONS!

### Reminders for Entrepreneurs

- Investors want to say, "No." You need to make them say, "Maybe."
- Make sure that you are "selling" something that that investor is interested in "buying."
- Understanding the arithmetic of deals is very important.
- Deals are negotiated with percentages, but they are structured with shares.
- $\text{Post-financing Value} = \text{Pre-financing Value} + \text{Investment}$
- $\text{Pre-financing Value} = \text{Post-financing Value} - \text{Investment}$
- Valuation is only meaningful in the context of the complete deal.
- Deals are complex. Ignorance is not a defense against unpleasant outcomes.
- Preferred stock provides the investor with extra benefits and rights as compared to the common stock shareholders.
- Stock options can disguise a reduction in the pre-financing valuation.
- Ask for a written term sheet so that you can evaluate the entire proposed investment before commenting on any of its individual features.
- Securing a written term sheet from an investor is an **extraordinarily important accomplishment** in the fund raising process.
- The potential investor's **perception of risk** will greatly influence whether he has an interest in investing in your company under any circumstances.
- In all probability, your funding is going to come from private investors, not institutional venture capital.
- There is no single "private investor." Each is an individual with his or her own views and sensitivities. Attracting an investment from such sources is not a "one size fits all" proposition.



- Private investors are less predictable than institutional investors. You need to understand and categorize potential private investors according to their **perceptions of risk**.
  - Do they know anything about the business?
  - Do they know you?
- Identify less than 10 individuals whose investment commitment will have a favorable impact on the investment decisions of others (**anchor investors**).
- Create a proactive fund raising game plan that you can execute to your advantage.
- Deal structures are only limited by the imaginations and expectations of the participating parties.
- You need to understand the complexities of different deal structures and select the ones that are acceptable to you.
- There are ways to raise money without giving up equity. Only a subset of potential investors will find such deals of interest.
- Surround yourself with professionals, mentors, and advisors who can help you level the playing field.



## Chapter 16

### Risk Reduction Techniques

By Frank Demmler

Throughout this series of articles, I have repeatedly emphasized that others' perceptions of risk had to be one of the first-time entrepreneur's primary sensitivities. To the extent that you will need others as you pursue your dream, and you will, their willingness to work with you will be greatly influenced by their perception of risk. Be it investment capital, time for meetings and advice, or even opening up a Rolodex to make an introduction on your behalf, people will only consider providing you with these scarce resources if they think you're going to succeed, or they think you deserve to succeed.

In many of the prior columns, I've highlighted how you can group potential investors based upon their perception of risk as it relates to your business and you. This week, let's look at a variety of other risk reduction techniques that you may employ to lower the **perception of risk**.

#### ***Demonstrate Your Ability to Perform Against Plan***

With advance planning, it is possible to use time as a strategic weapon in fundraising. Raising money is going to take months for most of you. If you cite certain accomplishments that should occur while you are in the fundraising process (a customer order, for example) and they happen, that can build significant credibility.

*Unfortunately, the converse is also true.*

#### ***Stage the Investment and Tie it to Milestones***

If the investment is divided into two or more increments, funding can be tied to the successful accomplishment of major milestones. A \$1 million financing may be divided into increments of \$300,000 at the initial closing, and \$700,000 at a subsequent closing contingent upon your meeting the agreed-to milestones.

Milestone investing is almost a "religious" issue within the investor community. Some investors swear by it and won't do deals any other way. Others have had bad experiences with milestone investing and try to avoid it.

#### ***Build in "Go/No-Go" Decision Points***

In addition to milestones, "go/no-go" decision points can be identified in a particular project. With the identification of these, exposure of the investor's capital can be prudently staged. For example, FDA approval represents such a "go/no-go" decision point in the medical products area. Getting a zoning variance may be needed for a restaurant or retail outlet to be launched. Usually there's a need for outside capital to get to the "go/no-go" decision points (product research and development, architectural drawings) that cannot be bootstrapped.

#### ***Use Credible Intermediaries***

Another risk reduction technique involves using intermediaries who have independent credibility.

If you use somebody to introduce you to the investor, the quality of the person who provides the introduction says a lot about you. For example, the CEO of a successful



company in which your targeted investor has placed money would be a very powerful intermediary for these purposes.

Similarly, using professionals (often called investment bankers) who have successfully raised money for similar businesses in the past can be an effective strategy. They already have a network of investors who will often invest in particular situations based primarily upon the recommendation of the financial professional.

*Before moving on, there are two important points related to the use of professional intermediaries.*

- *You must ask the question, “May I please have the names and contact information for three of my peers for whom you have provided these services?”*
- *Successful professional fundraisers use an upfront fee to screen prospective clients. Therefore, if the references check out well, you should not reject an upfront fee out of hand.*

This latter point is probably contrary to a lot of the advice you are likely to receive.

First, unscrupulous people do exist who prey on naïve first-time entrepreneurs. They will put on an impressive show and request a retainer for their services. Don’t fall for that.

I remember a time about 10 years ago that a firm from New York City used the Pittsburgh Technology Council’s membership directory as a source of cold call leads. They dangled the prospect of raising money before the CEOs of these companies, and cautioned these CEOs not to share the overture with anyone else because this firm had chosen their company based upon some unnamed recommendation. In several instances, CEOs and their teams went to New York to pitch their deals (at their own expense) after which the supposed fundraiser extolled the team’s virtues and expressed excitement about working with them. For a modest check (I think the range was \$10,000 to \$25,000, depending upon what they thought they could get) and a signature on an engagement letter (that relieves them of any responsibility or liability, although that won’t be obvious to you), they were ready to lead the CEO to the Holy Grail. I know of at least three companies that got bamboozled this way.

Still, if you check out the investment advisor with others for whom he has successfully raised money, then think long and hard before rejecting him if that’s the only reason for doing so. Your goal is to raise money for your business and if this person can materially improve your chances of doing so, especially as compared to other fund raisers who don’t charge an upfront fee, don’t be “penny wise, but pound foolish.”

### ***Halo Effect of Advisors***

Just as intermediaries use their credibility to attract investors, those people that you can identify as being involved in your company as mentors, advisors or board members, can also be very effective in lowering risk perceptions.

*There is one caution, however. If these individuals are not also investing in the company, a “red flag” will be raised with many investors and this may work to your disadvantage.*

### ***Third Party Confirmation or Endorsement***

Quite often an investor is going to be skeptical about the claims an entrepreneur makes. Therefore, independent sources, such as a trade journal article or an independent market study, that confirm critical elements of a business proposal can be a very effective tool in building credibility and investor interest.



***Relevant Analogs***

Comparing your business to one that is a known success can be a very effective risk reduction technique, and can help you describe your business in easily understood terms.

- The Wendy's of hot dogs.
- The Dell Computer of home theater receivers.
- The Siebel Systems of corporate innovation ([www.us-mindmatters.com](http://www.us-mindmatters.com), a plug for a local company, MindMatters Technologies, Inc.)
- The Domino's Pizza of Chinese food.

I'm guessing that at least one of these created an immediate impression in your mind. It didn't take pages and pages of text to do so, just a well-chosen phrase. What analogy works for your business?

**Reminders for Entrepreneurs**

- Always be aware of and sensitive to how others perceive the risk of your business.
- Take advantage of low-cost, or no-cost, ways to reduce the perceived risk.
- Be cautious and careful when using outside professionals with whom you haven't worked before.
  - *You must ask the question, "May I please have the names and contact information for three of my peers for whom you have provided these services?"*
- Surround yourself with professionals, mentors, and advisors who can help you level the playing field.



## Chapter 17

### Timing and Alternatives: Other Considerations about Raising Private Equity

*By Frank Demmler*

As I hope is obvious by now, raising money is not an easy undertaking. Trying to raise money will take you away from building your business on a day-to-day basis. You must keep in mind that it takes time to raise capital, probably longer than you ever imagined, and there is no guarantee that you will be successful in your efforts. You will have to run as many parallel paths as possible until a deal takes shape. During that period, you will likely be in “boot strap” mode. You must make a conscious decision that the opportunity costs and the potential downsides are worth risking.

#### **TIME TO RAISE CAPITAL**

The time it takes to raise capital can be excruciatingly long. As a rule of thumb, you should plan on anywhere from six to 12 months to conclude a successful round of fund raising. The primary steps are:

- |   |            |
|---|------------|
| 1. Develop a business plan  | 2-9 months |
| 2. Initiate discussions with potential investors                    | 2-4 months |
| 3. Respond to investor requests for additional information          | 0-3 months |
| 4. Bide time while potential investors do their due diligence       | 0-6 months |
| 5. Receive a term sheet and negotiate a deal                        | 1-6 months |
| 6. Prepare legal work, negotiate the fine points and close the deal | 1-3 months |

It is unlikely that your company would be at either pole for all factors. As a practical matter, if you haven't closed a deal within a year, it is unlikely that you ever will.

#### **ALTERNATIVES to raising capital**

Alternatives should always be considered. Raising money is rarely a linear path, so building in flexibility, as well as developing viable options will work to your advantage. Here are some of the questions that you should ask yourself:

- Can I make meaningful progress with less money? Is the perceived risk of my business such that I can use a small amount of money to accomplish one or two particular things that will set the stage for me to raise a larger amount of money later?
- Can I stage the investment? Can I close on a portion of the investment now, with the balance due upon successful completion of milestones?
- Can I get development funds from a customer or supplier who will ultimately benefit from my success? Will my suppliers and customers consider special terms and conditions for me? Might my supplier give me goods on consignment? Might my customer place a deposit at the time of an order, or at least agree to progress billings?
- Can I get a customer to pay for a custom development of my technology for them while retaining ownership of the intellectual property?



- Might money be available from an economic development agency? Typically, such agencies focus on jobs creation and retention.
- Are funds a possibility through programs like InnovationWorks, Idea Foundry, the Pittsburgh Digital Greenhouse, or the Pittsburgh Life Sciences Greenhouse?
- How about the Federal Programs like SBIR, STTR and ATP?
- Should I partner with a competitor who might be better able to exploit the commercial potential of what I'm pursuing?
- Would someone pay a licensing fee for limited license to my technology, perhaps by industry or geography?
- Can I boot strap for a while?
- Can I sell consulting or services to generate cash flow, create industry visibility, and secure referenceable customers?

### **Advice for Entrepreneurs**

- It is likely to take you twice as long to raise money as you think it will.
- Make sure you consider the opportunity costs of the fund raising effort before you launch it.
- Consider alternatives to raising private equity.
- Surround yourself with professionals, mentors, and advisors who can help you level the playing field.



## Chapter 18

### Valuation (B): Increasing your Company's Value

*By Frank Demmler*

Back in the fourth chapter of this series, I walked you through my view of the valuation process. This week we'll talk about ways that you can influence that process to your company's benefit.

First, let's recap some of the points in the prior article.

What is your company worth? It's worth whatever someone is willing to pay for it.

Valuation is more an art than a science. In my experience, valuation falls into a range of values. There's some number below which an entrepreneur will not accept an investment. Similarly, there's some number above which an investor will walk away.

Since investors want to maximize their return on investment, the valuation they are likely to propose will be toward the low end of the range. That number is not going to change materially in one-on-one negotiations. My guess is that increasing it 20% is at the outside of what you might be able to achieve.

The only way that I have seen to increase valuation significantly (by orders of magnitude) is to have competition, or credible perceived competition, for your deal.

#### **Who has the power?**

Let's revisit the original case. [The following characterizations are more caricatures, than reflections of actual behavior. You would never allow your company be this vulnerable. No investor would be as devious as the one described. These are extremes for the purpose of making point, .... or are they?]

You have been pursuing an investment from any source for months now. It has taken forever to get even one investor to come the point of preparing a term sheet and giving you a specific valuation for your company (as well as all the other terms and conditions do that impact your interpretation of the valuation). You are running out of cash, or have already done so and you're running on fumes. You need to do a deal, and you need to do it soon.

You take a look at the term sheet and your jaw drops. The valuation the investor has put on your company is only a fraction of what you believe your company is worth. You express your dismay and ask how that can be. The investor will cite other investment transactions with which he is familiar (and may have actually done) and explains the similarities and differences of your company relative to these other companies. He pulls up a spreadsheet on his laptop to demonstrate to you that by taking the projections in your business plan and making what he claims to be prudent adjustments to them, the results can be analyzed in the context of an exit and return potential. The valuation is a simple case of analysis and calculation. Numbers don't lie.

As you fight back tears (or your urge to punch him, depending upon how you react to surprises), he closes by telling you that he had to really go to bat for you with his partners because they thought the value should be even lower. "In fact," he warns you, "One said that there were better deals in the prospect list and that we should pass on your altogether!"



The investor's message is: Be thankful you've got a deal. Don't screw around, or the deal might fall through.

How can you respond? Can you go to another source of funding? [Not the way I've built this hypothetical case.] Can you appeal the investor's sense of "fairness"? Can you/should you convince yourself that a smaller percentage of the bigger pie is better than 100% of a small pie (or no piece, if the company fails)? Are you willing to crater your company on a "matter of principle"?

Quite simply: Who has the power? I hope that it's obvious that virtually all the power resides with the investor. Why would an investor increase a valuation that he has already justified to himself, his partners, and now to you, as "fair"?

### **Competition for the Deal**

Now, let's look at the same deal, but in this case, you've read all my columns. You've got yourself surrounded by a group of professionals and mentors who have helped you level the playing field. You are aware of the pitfalls of being forced to do a deal when you are only talking to one investor and you are about to run out of money.

Being sufficiently forewarned, you have done the following:

You have resisted the urge to increase your burn rate. You have avoided being desperate for cash.

Ideally, you can maintain a cash neutral level of operations, if necessary.

You have developed a strong relationship with at least one large firm that "gets it" and wants to work with you.

You have carefully chosen to pursue investment from potential investors who qualify as being "good" investors for you and two are close to offering independent term sheets.

Now, who has the power? You!

In my mind, this scenario is optimal for an entrepreneur seeking funding:

Two potential financially motivated investors

A potential strategic partner (they can play the role of wild card in that many strategic partners can offer very generous valuations if they invest)[That's not always a good thing, but we'll save that discussion for another day.]

You can walk from the deal.

It is not easy to pull this set of options together, but it is worth trying to.

Even when you've positioned things this way, you can screw it up and end up with nothing. If any of the parties thinks they are being "played," they are likely to withdraw immediately. In turn, the investment community is small enough that the rumor mill will spread that news like wild fire. Your honesty and integrity will be called into question.

The whole house of cards could come falling down.

### **A Real Life Example**

One company I know had but together the following:

- An interested financial investor
- A potential investment from a strategic partner
- A potential investment from a company looking for diversification
- An agreement among existing investors that they would provide bridge financing if it became necessary



The company preferred the financial investor in terms of its potential impact on the ultimate exit, but only if the terms of the deal were acceptable. Each of the other alternatives was viable, with positives and negatives. The company was willing to go in any of these directions. Each had a sense that the company had alternatives, but did not know the details or identity of the other possible players.

After setting these dominoes up, the company was able to extract a term sheet from the financial investor. The prior round of financing had been done at \$1.75 per share. The term sheet came in at \$1.25 per share! The company was not pleased, to say the least. The investor was told that while the company would like to work with it, these terms were not attractive. The company did not reject the term sheet, but the investors knew that the company was not happy.

The company's management quickly put the other options in play. They explained to each of the potential corporate investors that it had received a term sheet from an investor and that if they wanted their interests to be considered, they needed to put their offers in writing, which they did.

Things went round and round for a while, with each party walking gingerly. Feelings were being hurt. Egos were getting bruised. Each potential investor had withdrawn from negotiations at least once. The knots in the stomachs of the company's management were the size of watermelons. Finally, there was a sense that each party, including the company, was about at its limit, and the possibility of the deal falling apart was increasing.

The company told each investor that it was going to hold a board meeting and that it would make a decision at it. By this time, the financial investor had increased its offer to \$1.80 per share, claiming that an "up" round was generous.

The board meeting was called into session and discussion ensued. Phone calls were made to each potential investor to clarify certain points and to determine if any were willing to improve their offers. There was some movement by each, but nothing significant. The board was still interested in the financial investor's deal, but was split on whether the terms were going to be acceptable. A final call went out to each investor. They were each told the concerns the company had with each deal. The potential investors were told to make their final offer. By this time, the company's attorney was having these discussions as the involved parties might have had trouble maintaining a dispassionate tone on the phone.

Cutting to the punch line, the financial investors offered \$3.00 per share which was acceptable, and that deal closed. The progress made in those last few hours probably added about \$20-30 million to the exit value of the existing investors and management.

### **Advice to entrepreneurs**

- You need to begin preparing for these discussions TODAY.
- A key factor in negotiations is the relative power of the participants.
- Being able to walk from a deal is very powerful.
- The first-time entrepreneur needs to plot a fund raising strategy in advance and execute against that strategy.
- If at all possible, avoid having to do a deal with only one investor. Creating the perception of competition, if no firm alternatives exist, can be used effectively, if



necessary, but such posturing can also backfire. Think through the consequences of your actions and make sure you can live with a worst case outcome.

- BE HONEST AT ALL TIMES!
- Build a network of mentors, advisors, professionals, and entrepreneurs who have “been there and done that,” particularly in your market space. They already have the battle scars. They will have awareness of recent transactions and valuations.

As a first-time entrepreneur, you do not need to put yourself at the mercy of the investment community, but it’s your job, not theirs, to prepare yourself to engage in valuation discussions when you are seeking capital.



## Chapter 19

### VENTURE CAPITAL vs. venture capital

*By Frank Demmler*

The words, “venture capital,” are used quite frequently in discussions of entrepreneurial finance, but to different people, they mean different things. It is essential that the first-time entrepreneur knows the differences and uses the term correctly.

“VENTURE CAPITAL” is professionally managed investment capital targeted for new and emerging companies in which investments have the potential to yield extraordinary returns.

“venture capital” is a generic term that the man-in-the-street uses to describe all forms of private equity that might be invested, on some basis, in privately held, smaller firms.

Quite often, the person using this term is referring to angel, or individual, investors.

The first-time entrepreneur should only use this phrase to refer to VENTURE CAPITAL, the professionally managed money. To do otherwise is likely to cause confusion, and has the potential to be viewed as a lack of sophistication, which could reflect poorly on you and your business.

#### **Professional Venture Capital**

Right now, you may be thinking that I’m splitting hairs. “What’s the big deal?”

A recurring theme throughout this series of articles has been to encourage you to make the most efficient use of your time as possible. In fund raising, that means only pursue sources that are viable providers of capital to you. The corollary to that is that you need to understand the investment objectives of the investors you approach and make sure that the investment you pitch to them is something in which they are interested.

For you to do this with regard to VENTURE CAPITAL, you need to understand what makes them tick. I hope to provide you with some of that insight in today’s column.

Let’s look at a typical activity sequence for a professional venture capital firm. (To my VC friends, I apologize in advance for this oversimplification).

1. Create a ten-year limited partnership with the venture capital firm the general partner.
2. Raise money from investors. [Yes, just like you, a venture capitalist is an entrepreneur who needs to raise money.]
3. Invest the capital in opportunities that meet its investment criteria, AND pass the internal approval process.
4. Work with the portfolio companies to help them build value and move them toward an attractive exit.
5. Achieve exits when possible and distribute the proceeds to its investors.
6. Do it all again.

Pretty simple, huh? No big deal. Let’s look at these steps in greater detail.

#### **Limited partnership**

One of the key things you need to appreciate is that the money you seek from a venture capitalist will be coming from an entity that has a ten-year life. You need to know the



vintage year (the year it started) of the fund from which you are seeking investment. If the fund is in its eighth year, then it is probably not making any new investments, particularly in early stage companies.

In fact, most funds try to make the majority of their investments and commitments in the first three or four years. The combination of investments, commitments, and reserves (investment capital held back for use with existing portfolio companies under a variety of circumstances) is likely to leave the fund with very limited “dry powder” for new investments.

This also why the professional venture capitalist is raising a new fund when the current fund is only a few years old (Step 6, above).

### **Raise money from investors**

Just like you, the venture capitalist has to convince investors to invest in its fund.

If it's a first-time fund, it is extremely difficult to convince investors to take that risk (just like first-time entrepreneurs).

If it's a second, third, or fourth fund, past performance will have a major impact on whether the existing investors will invest additional capital in future funds managed by that particular venture capitalist. Furthermore, investors who have not invested in the prior funds are likely going to want to see that many of the existing investors invest in the new fund.

Who are these investors? According to the National Venture Capital Association, the investors into venture capital limited partnerships break down as follow:

Pension Funds	42.0 %
Financial Institutions & Insurance	26.0 %
Endowments & Foundations	21.0 %
Individuals & Families	9.0 %
Corporations (as LPs)	2.0 %

All of these are professionally managed sources of capital themselves for which venture capital is an asset class, often limited to less than 5%. Their investment in any limited partnership is likely to be tens of millions of dollars. Such investment decisions are not made lightly.

### **Investment criteria**

Each venture capital fund has its own investment criteria. Some of the likely elements are: size of initial investment; total investment opportunity, including follow on investments (most funds can not commit more than 10% of the fund's committed capital to any one deal); industry; stage; and geography.

Don't expect them to deviate from their criteria because yours is such a great deal. For an example, a \$500 million venture capital fund is not going to make \$1 million investments. They need to put more money to work in any given deal to make it worth their time.



### **Approval process**

All funds have an internal approval process for making investment decisions. Just because a partner endorses an investment in your company doesn't mean that his partners will agree. Many funds require a unanimous approval of all partners.

Your challenge, then, is to make the partner with whom you are working your aggressive champion within his partnership. When he makes an investment recommendation, he is putting his credibility and ego on the line. You have to convince him that it's worth the personal & professional risk to do so.

### **Build Value & Exit**

This is the normal, everyday blocking and tackling that a venture capitalist does to provide his value added. These activities consume a very large portion of a venture capitalist's time.

If you consider an investor's assistance "meddling," venture capital is not for you.

### **Do it again**

For venture capital to be a professional career, a venture capitalist must be able to raise a series of venture capital funds. As noted before, this requires that a significant number of the investors in the existing fund participate in the next fund. Only by layering funds of different vintages on top of one another can a venture capital firm sustain itself.

You need to understand this and be able to make the case that an investment in your company will assist the venture capitalist in those efforts.

### **Advice to entrepreneurs**

- "Venture capital" refers to professionally managed investment capital.
- Use the phrase, "venture capital" correctly.
- Don't expect venture capitalists to deviate from their investment criteria because yours is such a great deal.
- You need to make the partner with whom you are working your passionate champion within his venture capital partnership.
- If you consider an investor's assistance "meddling," venture capital is not for you.
- You are selling an investment opportunity to a venture capitalist. Make sure that you select the firms to approach based upon their investment criteria. Make sure you demonstrate to them how you will satisfy (exceed) their investment objectives, thereby contributing to their success as a venture capitalist, and their ability to raise additional funds.
- Build a network of mentors, advisors, professionals, and entrepreneurs who have "been there and done that," particularly in your market space. They already have the battle scars.

As a first-time entrepreneur, you need to master the vocabulary of your chosen pursuit. If you desire and/or require venture capital investment, then make sure you understand things from their side of the table.



## Chapter 20

### Deadlines: The Power of Commitments & Deadlines

*By Frank Demmler*

If you're like me, and regretfully, a number of you are, you always have more things to do than time to get them done. Like me, I'm guessing that deadlines (urgency, in Stephen Covey's vernacular) drive what you do way too often as compared to priorities (importance).

For example, I'm writing this article Sunday afternoon because I know Steve Czetli is patiently (?) waiting for it so he can publish Monday's issue of TechyVent. I should have done it earlier, because this is important to me, but things kept on interfering, so now I sit here in urgency mode.

Enough about me, let's talk about you.

#### What's Important?

I hope that some of you have benefited from these weekly columns. I hope that many of you feel that you've learned something, and that somewhere along the line, you may have had an "Ah, ha!" moment, as in, "Ah, ha! Now I get it!"

Further, I'm going to **assume** [One of my two least favorite words in entrepreneurial settings; the other one being, "**interest**."] that raising money for your venture is **IMPORTANT** to you. If that "assumption" is accurate, then my question to you is, "What have you taken from this series of articles and applied to your business and fund raising efforts?"

If you're like many of the entrepreneurs I've worked with, the answer is probably, "It's in my To Do stack and I'll work on it when I can get to it. After all, I've got a business to run here."

Sound familiar? As they say, "When you're up to you're a\_\_ in alligators, it's hard to remember that you're in there to drain the swamp."

For many of you, though, resolving your fund raising strategy and implementing it is critical to your ability to "drain the swamp."

You may not need, or want, outside capital, and that's fine and probably the right decision for many of you. Have you considered the implications of organic growth and the constraints of growing without external capital? Have you considered the alternatives, including raising outside capital and made an informed and intentional decision that you are going to go it alone? If so, good for you.

If you haven't done that analysis and come to that conclusion, then you need to go through that exercise and make a commitment to it.

If, on the other hand, you know that you will need access to some outside capital, then you've got to make that a priority and act upon it. If not, you're running at a cliff (running out of cash), and you're going to go running right over the edge!

I know, I know. You're thinking that this sounds good in theory, but it's next-to-impossible to make happen in practice. Not so, dear reader, and I will share my solution to this conundrum with you.



## Your Mentors & Advisors

Throughout this series, I have closed almost every column with the advice that you need to surround yourself with people who will help you level the playing field when you are trying to raise money. Well, if you do the job right, and engage these individuals with the respect and consideration they deserve, they can play an essential role in helping you to get the right things done on time.

While the full scope of a constructive relationship with such individuals is the topic for a complete column, in the context of today's discussion, suffice it to say that you need to communicate with your advisors with a certain amount of frequency and occasional direct personal interaction.

If so, they are likely to see the "big picture" even better than you, who's "up to his a\_\_ in alligators." They can bring a perspective to your situation that can help you identify and prioritize the important issues that need to be addressed. They can help you determine the activities that must be completed.

NOW COMES THE IMPORTANT PART, you need to make a commitment to them that you will get certain tasks done by a certain date! It's that simple. If you are going to be a successful entrepreneur, your integrity must be above reproach. You have an inner compass (stealing metaphors from Covey, again) that won't let you go back on your word. If you make a commitment, you will keep that it.

## How this applies to fund raising

Deadlines for investor presentations can be extraordinarily beneficial for entrepreneurs. Such deadlines create urgency. They force you to resolve some of those fuzzy issues that are floating around in your head. They make you consider what your audience wants to hear, how to present it, and to prepare responses to their anticipated questions.

This is a very real phenomenon. At the Enterprise Corporation of Pittsburgh, we had a program called the Private Investor Group [the acronym was an intention inside joke]. Virtually every month, Tom Canfield and I would help an entrepreneurial venture prepare to make a presentation to a group of private investors.

By virtue of having to get prepared for the presentation, it's my estimate that the entrepreneurs gained orders of magnitude of sophistication and appreciation during the six weeks leading up to the presentation.

Over the last two years of the Enterprise Corporation, 17 out of 22 presenters were able to raise funds, many as a direct result of the presentation and its preparation. This success is not a coincidence!

If you have an opportunity to present to a group of investors in virtually any venue, do it! You may not raise money as a direct result, but you will significantly raise the probability that you will raise money eventually.

Commitments and deadlines will contribute significantly to your fund raising prospects.

Note: InnovationWorks sponsors the successors to these efforts, Southwestern Pennsylvania Angel Network (SPAN), for its portfolio companies, and co-sponsors LifeSPAN that focuses on entrepreneurial ventures in the life sciences arena with the Pittsburgh Life Sciences Greenhouse. Go to the [InnovationWorks](#) website for more information, or contact [Matt Harbaugh](#), Director of External Finance at InnovationWorks.



**Advice to entrepreneurs**

- Make important things urgent, so you can assure that you will get them done.
- Make commitments to your advisors and mentors, and live up to them.
- If you're given the opportunity to pitch your deal, DO IT!
- Build a network of mentors, advisors, professionals, and entrepreneurs who have "been there and done that."



## Chapter 21

### What Do You Want To Do When You Grow Up?

*By Frank Demmler*

“What the hell has this to do with fund raising,” you may be asking yourself. The answer may surprise you, “Everything!”

Why did you start your business? What do you want your business to be doing in two, five and ten years? How do you define success? When you look back in five or ten years, will you be proud of what you’ve achieved?

The answers to these questions, and others like them, are critical in your quest for capital. The kind of business you want to create and the role you play in it are essential to determining the desirable sources of capital for you and your business.

#### **What Kind of Business do you want to create?**

Many first-time entrepreneurs come up with a business idea and mistakenly believe that there’s only one way to create a business around it. This simply is not true.

The nature of the business is largely dependent upon the business you want to create. If you don’t probe and challenge yourself to create different business concepts that can be derived from your core idea, then you may miss the path that would give you the most satisfaction or that may have been the most successful financially. By going down the “obvious” path, you may be dooming yourself to failure, or building a business that is neither satisfying nor rewarding.

How many pizza shops do you know? How many are, or have the potential to be, a regional, or national, chain? What’s the difference? Why have Jim Fox of [Fox’s Pizza Den](#) or Varol Ablak of [Vocelli Pizza](#) (fka Pizza Outlet) created chains when most pizza shops are single units run by the owner?

Part of the answer is they had “been there, done that” and believed that they had concepts that could be the foundations of chains. Part of the answer is that they believed they could do it. Part of the answer is that they believed that they would be able to get others to believe in their visions, be it potential management team members, investors, or franchisees.

The following may not be entirely accurate, so I apologize in advance.

[California Closets](#) is a successful chain of closet efficiency systems founded in 1978.

The inventor of the initial closet system was a junior at one of the branches of the University of California (I think it was Santa Barbara). He was a jock and he needed a way to store all his sports stuff (shoes, balls, equipment). In his dorm room he had a closet, a chest of drawers, a desk and a bed. With a spark of inspiration the closet efficiency system was born! It spread among his friends who wanted it for their closets and soon he had to train others how to do it as he took the orders and managed the operations. Someone said, “Let’s franchise this!” and the rest is history. In the late 1980s, California Closets was one of the fastest growing franchises in the country.

**BUT**, to the best of my knowledge, the closet organization and efficiency system was invented in 1976 in Pittsburgh! [Ed Margolis](#) is a professional architect who specializes in bringing local housing stock that had been built in the early 1900s into the modern era;



plumbing, electrical, windows, HVAC, etc. One of the challenges that was common among these houses was that they mostly had nine-foot ceilings and the closets were your standard one shelf with a hanging bar under it, with all sorts of unused space. Ed would design innovative ways to use that space. Soon, by word of mouth, people learned about the wonderful things Ed was doing for closets and people began calling him for just that. Well, his primary focus was working on complete houses, but this presented an opportunity to start a side business to satisfy the demand for the closet systems. He launched [Closet Tier](#) in 1974 and it has been a fixture in Squirrel Hill ever since.

The point I'm making here is that essentially the same idea has two dramatically different outcomes, and BOTH WERE SUCCESSFUL WITH RESPECT TO THE GOALS OF THE ENTREPRENEURS WHO FOUNDED THEM.

In the Information Technology (IT) arena, it may not be obvious whether you should create a product around your proprietary technology, or use it to deliver a value-added service. Either may be viable, but what resources will be necessary to launch each?

Which path is preferable to you? Are they mutually exclusive, or might you start as a service company and evolve into a product company once you know what value your customers are really getting from your offering?

That raises another issue of which you must be aware if you're a first-time entrepreneur. You won't really know what business you're in until your customers tell you. Quite often the business you start and the business that emerges may look very different from one another.

One of the most dramatic examples of this occurred with serial entrepreneur, Don Beaver. Don and his partner, Ben Stapelfeld, had started industrial contract cleaning and maintenance company in the late 1970s. The company was struggling and one of its biggest headaches was cleaning factory floors where oil had leaked from the machines. They tried all sorts of combinations of absorbent material and something to hold it. Finally the combination of ground up corn cobs inside a pair of pantyhose worked! This gave them a significant cost savings and their service firm began to win more contracts and make some money.

One of the plants that they serviced was a supplier to the Ford Motor Company. One day the Ford inspector for vendor compliance was inspecting this particular plant and he noticed the strange things wrapped around the bottoms of many of the machines. The plant manager told the inspector what they were, and he expressed interest in buying some. The plant manager explained that it was his contract maintenance service provider who put the items there, and he gave the inspector Don's work number.

The inspector called and the conversation, according to legend (and/or my faulty memory) went something like this.

Inspector: "Hello, I'm from Ford Motor Company and I would like to buy four gross of your absorbent socks."

Don: "Well, sir, we are a service company and that diaper for leaky machines that you're referring to is one of the tools we use to provide superior service to our customers. We would be more than happy to bid on your service contracts."

Inspector: "You don't understand. I'm from the Ford Motor Company. I have a unionized work force that does our maintenance and cleaning. I do not want your service. I want to buy four gross of your 'diapers.'"

Don: "Yes, sir! And where should we ship them?"



In that nanosecond in 1985, [New Pig Corporation](#) was born. The last time I heard, and that was over 10 years ago, New Pig had revenues of over \$65 million!

**Advice to entrepreneurs:**

- Make sure you know why you are starting your business.
- Make sure you consider the different ways that your idea could be commercialized and make a fully informed and considered selection of the path you decide to pursue.
- Listen to your customers. They will tell you what business you are in. You may be surprised.
- Build a network of mentors, advisors, professionals, and entrepreneurs who have “been there and done that.”



## Chapter 22

### The Roles of the CEO and Founders: Be Careful What You Ask For

*By Frank Demmler*

In the last chapter, I started the column with a particular point to make, but by the time I finished telling entrepreneurial “war stories,” it would have taken me another column’s worth of explanation to tie it all together.

This week then, I’m going to lead off with last week’s original point to make sure it gets made:

**SIX OUT OF TEN CEO-FOUNDERS OF VENTURE CAPITAL-BACKED COMPANIES ARE NO LONGER WITH THEIR COMPANIES WITHIN FOUR YEARS OF RECEIVING THEIR FIRST VENTURE CAPITAL INVESTMENT.**

I hope that’s a sobering thought.

#### **The road to hell is paved with good intentions**

Once an entrepreneur and a venture capitalist have successfully proceeded through the mating process and have closed on a deal, everyone is supposedly on the same side of the table and pushing in the same direction.

In an ideal world the first-time entrepreneur will execute well against his plan.

Constructive relationships will be created among management, investors and the board of directors. Unanticipated events will cause minor mid-course corrections, but the company will weather those storms. Over time the company will grow and prosper ultimately providing an exit for the investors through an acquisition or initial public stock offering. Presumably the entrepreneur has set the stage for his personal goals, be it cashing in himself, or achieving a platform for explosive growth through the liquidity event. Everybody’s happy.

In fact, if you are the first-time entrepreneur, you expect this to happen.

If you are the venture capitalist, you hope this will happen, but you don’t really expect it to.

Your experience is likely to be that over half of your portfolio companies will never achieve the commercial (and financial success) that had been hoped for. Less than 30% will provide attractive returns, and less than 5% (1 out of 20) will be the “home runs” that “make the fund.”

Also, as a venture capitalist, while you really do hope that the founder-CEO will grow with business and continue in the role of CEO throughout this process, you know that’s highly unlikely. Further, if the founder is not the long-term CEO, you hope that the founder is sufficiently mature and self-aware that he can play an ongoing and meaningful role with the company. But being realistic, you know that it’s better than 50-50 that the CEO-founder will have to be separated from the company.

You hope that this founder will prove to be the exception that proves the rule, but in your heart-of-hearts, you don’t really expect that to be the case.

“How can this be?” you may ask. Everything you’ve heard about this process has been that the investor bets on the jockey, not the horse. You’ve heard the standard VC



observation, “I’ll take an A team and a B idea every time over an A idea and B team. The A team will figure out how to make the business work. The B team isn’t likely to,” more times than you care to remember. If this is true and they’ve invested in you, then they must consider you part of an A team.

The irony is that they do, at the time of the investment. You are the right person to lead the company today. You’ve gotten it this far and you will be important in taking the company to the next level.

### **Frequent first-time entrepreneur behavior**

BUT the likelihood that the company will achieve this new level without some serious challenges along the way is unlikely. Will you rise to the challenge? Will you be able to work with your board and investors to take the necessary steps? Do you even know how to respond to these bumps in the road? Do you have the skills to execute these responses? Very frequently, in my experience, first-time entrepreneurs will assume a bunker mentality. Due to inexperience, misplaced loyalties, personality quirks, or any of a number of reasons, a first-time entrepreneur may do exactly the wrong things. Instead of discussing the circumstances, he hides them. Instead of preparing the Board and investors of likely unpleasant future events, he plays “ostrich” and hopes they go away. All of these things undermine the relationship with the Board. If it gets to the point where the Board doesn’t trust the founder, then a change in CEOs is the likely to occur.

**Note that it isn’t the business issues, per se, that cause the separation of a CEO from a company, it is the relationship of the CEO with the board and their faith in him.**

Even when your company achieves that next level, there are no guarantees that you will be an A player under these new circumstances. The skills that made you an A player at the time of the investment may not be the ones the company needs to achieve commercial traction. It is the rare person who can create a company as well as lead its commercialization efforts.

### **Revisiting control**

“But, I still own a significant part of the business. They can’t just throw me out, “ you may protest. Yes, they can.

Even if you owned over 60% of the outstanding stock at the time this occurs, the nature of the deal that you did with the VC to get its money will contain such provisions.

When you take outside investment, your company is no long YOUR COMPANY, particularly if the outside investment is from a venture capital firm.

As part of the deal, percentage ownership and control will be separated. Typically, there will be a shareholders agreement in which all shareholders, including you, will agree to vote their shares for a specific board structure. For many early stage companies in this situation, it is common for the board to have five members, two nominated by the founder (or common shareholders), two nominated by the investors (or preferred shareholders) and one mutually agreed upon. Your signature on this shareholders agreement takes precedence over your percentage ownership rights. I do not know of any VC that would do a deal that didn’t have such provisions in it.

So, returning to corporate structure 101, the shareholders elect the members of the Board of Directors. The Board then chooses the management of the company. Since you do not



have an absolute majority, you are at risk. If the investor board members can convince the independent third party that a CEO change is needed, then you are out!

In most cases the “hand writing is on the wall,” and some negotiated separation can be structured. If such a negotiated agreement cannot be worked out, the legal agreements will serve as the default rules. In most cases, you won’t want that to be the case. Work out a deal.

**Advice to entrepreneurs.**

- Accepting venture capital is not without its risks.
- Do not assume that you will be the exception that proves the rule.
- It is essential that you build constructive, positive, high-integrity, mutually respectful relationships with the members of your board and your investors.
- Be careful what you wish for. You may get it.
- Build a network of mentors, advisors, professionals, and entrepreneurs who have “been there and done that.”



## Chapter 23

### Is a Small Piece of a Big Pie Worth Much?

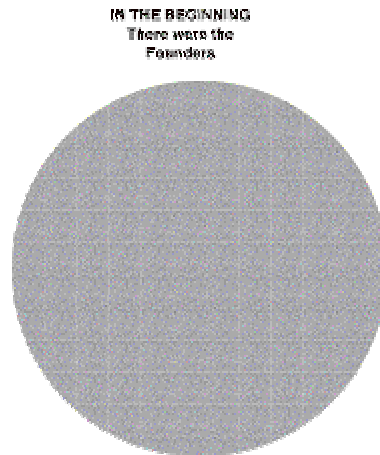
*By Frank Demmler*

When a venture capitalist is speaking to a first-time entrepreneur and valuation comes up, almost without fail, the VC will tell you, “A small piece of a big pie is better than a large piece of a small pie.”

Usually the conversation stops there. Apparently the compelling logic doesn’t require explanation. This week, we’re going to put some numbers around that statement, and you can decide for yourself if it’s meaningful or not.

#### **In the beginning, there were the founders**

When a company is first launched, the founders own 100% of the company.



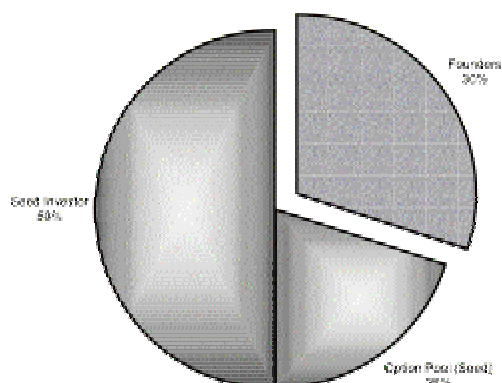
Company Valuation	?
Founders' Ownership	100.00%
Founders' Value	?

#### **The seed round**

Attracting an initial, seed round of investment can be a mixed blessing for you. On the one hand, you're ecstatic that you've attracted investment and can now pursue your dream with vigor. But on the other, you're in shock over how much of your company you've had to sell to get it. You sure hope that this concept of a smaller piece of a bigger pie works for you!



## SEED ROUND

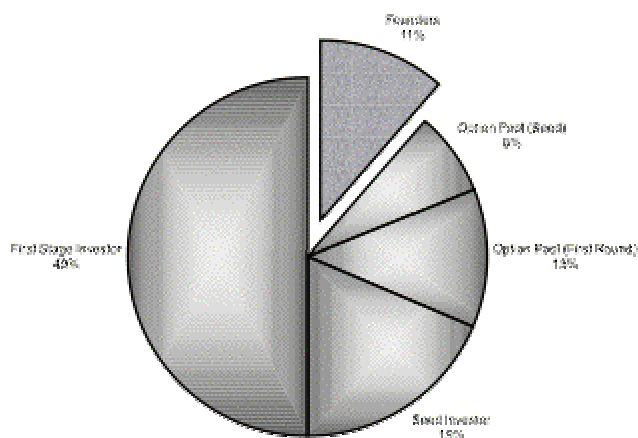


Company Valuation	\$2,000,000
Founders' Ownership	30.00%
Founders' Value	\$600,000

**The First Round**

Well, things have gone well. You've been able to attract an investment from a venture capital firm at a step up in value. Your share of the company has gone down again, but not to the degree you suffered with the seed round. While still concerned about the "smaller piece" issues, your paper value is moving in the right direction.

## FIRST ROUND

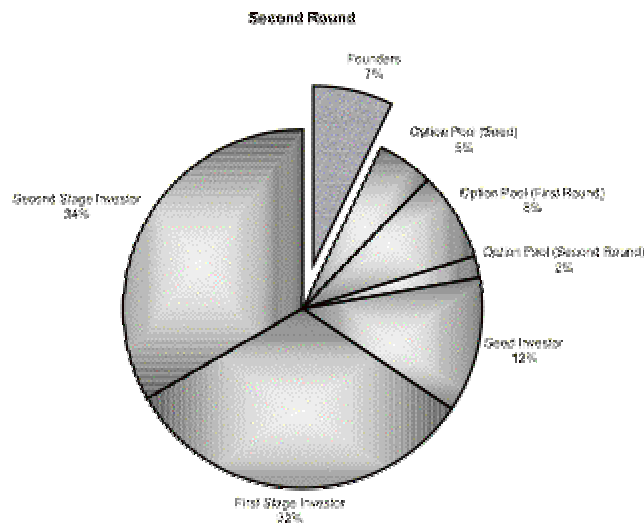




Company Valuation	\$10,000,000
Founders' Ownership	11.25%
Founders' Value	\$1,125,000

### The Second Round

Damn, you're good! Things continue to progress according to plan and a big league, first-class, well known and highly regarded venture capitalist has made a significant investment into your company, again at a step up in valuation! And the VC is only investing because they think that they can get at least a five times multiple on their investment. If things go well, next step is an IPO!



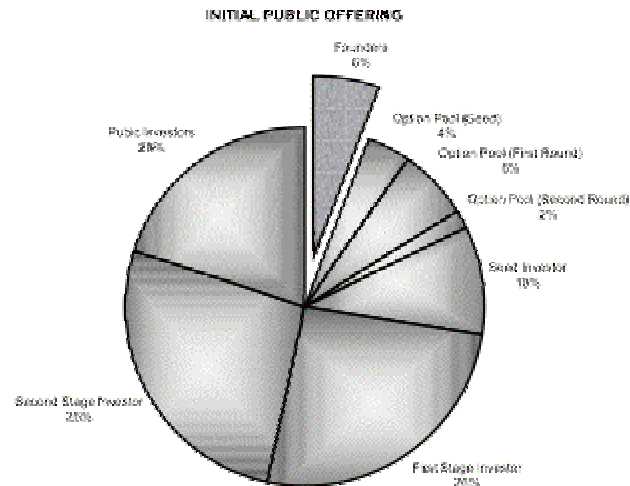
Company Valuation	\$30,000,000
Founders' Ownership	7.27%
Founders' Value	\$2,179,688

### Initial Public Offering

Halleluiah! You've gone public, just like you had hoped you would all those years ago when your seed investors convinced you that a smaller piece of a bigger pie was what you had to work for!

Guess what? They were right!





Company Valuation	\$187,500,000
Founders' Ownership	5.81%
Founders' Value	\$10,898,438

### Advice to entrepreneurs

- Never, in the history of venture capital and entrepreneurship, has a company ever hit its plan.
  - The vast majority, well over 90% in my experience, are below plan, often WAY BELOW plan.
  - A very small fraction exceed plan and exceed the hoped for exit opportunity for the investors.
- As has been noted previously, it is the rare founder who can grow with his company and meet the changing demands placed upon management as the company grows and prospers.
- For this specific scenario to play out, the company has to be able to attract next round investment at increasingly higher valuations. In recent years that has been extraordinarily difficult and rare. Many follow on rounds have been at LOWER valuations.
- Stock option pools will be part of your company if you attract institutional investors. In terms of their impact on valuation, they are really neutral, as long as you include them at appropriate levels in your fund raising efforts and integrate their impact when negotiating each round.
- Venture capital investment is not for every company, even if it were available to you.
- All of the related calculations were the result of converting percentage endpoints into numbers of shares. After all, deals are negotiated with percents, but structured with shares.
- Build a network of mentors, advisors, professionals, and entrepreneurs who have “been there and done that.”



## Chapter 24

### Cutting Up the Founders' Pie

*By Frank Demmler*

Two friends decide to start a business. “We’ll go 50-50,” one says to the other.

Three graduate students have worked on a research project that they want to commercialize. “Just like the three musketeers; all for one; and one for all. We’ll split the company three ways equally.”

Four neighbors share passions for baking. “Let’s start a catering business,” says one.

“That’s a great idea! One hundred divided by four means 25% each,” responds another.

That’s a story that repeats itself multiple times every day. IT’S ALSO ONE OF THE MOST COMMON MISTAKES FIRST-TIME ENTREPRENEURS MAKE. In fact, my friend, Fred Beste of Mid-Atlantic Venture Fund, attributes two of his famous, “Twenty-Five Entrepreneurial Deathtraps” to this issue.

You did see the word, “deathtraps,” didn’t you? As in, the company crashes and burns. As in, best friends become vicious enemies. As in, a family’s net worth goes down the drain.

Within thirty seconds of deciding to start a business, the seeds of its destruction are sown.

#### **In the beginning, there were the founders**

When a company is first launched, the founders own 100%. As already indicated, the often-used method for dividing that 100% is to divide it by the number of founders. “It’s fair,” is the common explanation. Have you ever heard, “The road to hell is paved with good intentions”? This is a prime example.

#### **What if...**

Before I discuss what should be done, let’s look at a few “hypothetical” situations. What if:

- You put in 10 hour days, six days a week and your “partner” shows up at 10:00 a.m. and leaves at 3:00 p.m., except on days when he’s got an earlier tee time.
- You quit your job, forego salary, while your “partners” stay in their jobs “to help fund the business” until it can afford “to pay them.”
- Every time you try to do something that you consider important, but costs some money, your two “partners” veto it.
- You want to raise investment to help the company realize its potential, but your “partners” don’t want to take the risk. “We’re doing just fine the way we are.”
- The company is running through cash flow raindrops and can’t cover payroll, so you draw down your savings to make the checks good. Your “partners” can’t come up with their “fair share,” but they assure they will when they can, but never do.

I could go on and on, but I think you get the picture.

Things to consider



You need to consider the past, current, and future contributions that each of the founders will be bringing to the company.

### ***Idea***

The company wouldn't exist if it weren't for the original idea, and that is certainly worth something, BUT there's a lot of truth in the saying, "A successful business is 1% inspiration, and 99% perspiration."

### ***Business Plan Preparation***

The development of an initial business plan is a surprisingly difficult and time-consuming effort. To pull together and organize all the thoughts of the founding team, filling in the blanks, identifying and reconciling the differences, and producing a document that captures the essence of the business and helps persuade banks, investors, board members, and others to support the company is a mammoth undertaking, as anyone who has done it will attest.

Again, the plan is a necessary element of starting the business, BUT execution against the plan is where the real value lies.

### ***Domain Expertise***

To what degree do you and your partners have meaningful experience in the business of your business? Knowing the industry, having relevant experience, and having a Rolodex full of accessible contacts can greatly improve the company's probability of success and speed its growth rate. Otherwise, it will take longer to get commercial traction and you'll have to pay for these assets, usually by hiring someone and including equity in their compensation package.

### ***Commitment and Risk***

You've probably heard the old saying that "a chicken is involved with breakfast, but a pig is committed." Similarly, the founders who join the company full time and are committed to making it a success are much more valuable than founders who are going to sit on the sideline and cheer you on. In addition, the opportunity cost of joining the company rather than pursuing an existing career is not trivial.

### ***Responsibilities***

Who is going to do what? Who is going to go stay up at night when you can't make tomorrow's payroll?

As an aside, it is my very strong recommendation that someone has to be the "boss."

Your primary strength against your competition is the speed with which you can act.

Don't neutralize that by debating every decision among the founders. Usually, any quick decision is better than the "right" long and drawn out decision. Even if you ignore all of this unsolicited advice and decide to be "equal" founders, I encourage you to make one of your team a "little more equal" than the others.

## **Advice to entrepreneurs**

- Splitting up the founders' pie is not a trivial undertaking.
- Rarely should it be split evenly, even though that's what many start-ups do.
- Consider the past, current, and future relative contributions of the founding team members to the ultimate success of the company.
- Build a network of mentors, advisors, professionals, and entrepreneurs who have "been there and done that."



## Chapter 25

### Working with Your Board of Directors

*By Frank Demmler*

One of the things that comes with an investment is almost always the creation of an active board of directors to which the investor is elected.

The reactions of first-entrepreneurs range from,

- “Great! I need all the help I can get,” to
- “What’s a board and what does it do?” to
- “I don’t need anybody looking over my shoulder and second guessing all of my decisions.”

The first time you do this you’ll probably have a bit of each running through your head.

#### **Your Board of Directors**

Your board should be a tremendous asset to you and your company. Let’s be honest, you’re probably doing a lot of “business things” for the first time. For high growth rate companies, the cost of tuition for on-the-job training is likely to be too high. The company can’t wait for you to learn your job as CEO by trial and error. Decisions need to be made. Strategies need to be formulated. Key management additions need to be recruited. The next round of capital needs to be raised. Oh, yeah, you’ve got a business to run and you may be doing that for the first time, too.

#### ***Corporate governance***

The legal role of the board is to look out for the interests of ALL shareholders. Even if you own a majority of the stock, your board cannot and will not just rubber-stamp your requests. Each board member has a fiduciary responsibility, and liability, for assuming this role.

Among other things, the board does hire and fire key management, including (or especially) the CEO.

#### ***Strategic discussions***

Your company is going to come to lots of intersections on the road to its success.

Sometimes the path you choose will be irreversible, and if it’s the wrong one, your company will falter, and perhaps fail.

If selected and used properly, your board members, drawing upon their expertise, contacts, and experience, can help you avoid fatal steps and make the proper decisions.

[Note: I originally wrote “right decisions,” but there are no “right decisions,” only best decisions appropriate to the current circumstances.]

Your board meetings will provide forums to review these issues, share experiences, discuss and evaluate the alternatives, and come to appropriate conclusions.

#### ***Anticipating & preparing for future issues***

Another key role for the board is to anticipate future issues and prepare for them. As noted in the opening of this article, you are probably doing this for the first time. You’re having enough of a challenge dealing with the here and now. You have neither the experience nor time to give a whole lot of thought to future issues.



That's where your board comes in. They can anticipate the type of financing you are likely to need in the future and begin the process of introducing appropriate investors to the company. They can see the trajectory of the company's progress in product development, sales, business development, and anticipate the areas that do, or will, need bolstering.

### **What A Board Meeting Is NOT for**

One of things that continues to surprise me is that many board meetings that I have participated in or observed, have been largely a waste of time.

#### ***Information exchange***

Board meeting are not for information exchange. You need to prepare and distribute a board pack (a collection of reports, charts, graphs, narratives that informs and educates the board members on what the company has done since the last meeting).

YOU SHOULD NOT REHASH THE CONTENTS OF THE BOARD PACK. If you got it to the board members with sufficient time for them to review it, assume that they have done so. Treat them with the respect that reflects your regard for their professionalism (by being prepared), and sensitivity to the importance of their valuable time. [Note: if one board member is not prepared, the others are, and the lack of preparation is obvious, it won't happen a second time.]

#### ***Surprises***

Board meetings should not contain surprises. In my experience, first-time entrepreneurs often assume an "ostrich posture" with regard to problems: they bury their heads and hope the problem will go away. It won't.

If there's a possibility that a problem of board significance may arise, tell your board members as soon as you get any inkling that it may actually happen. Whenever there's a significant surprise, good or bad, anticipated or not, tell your board.

"I can't do that," you may be thinking. "The board will question my ability as CEO." No, they won't. They will think that you are a sophisticated CEO, confident in your own abilities, and that you are wise to keep them informed about important issues, and to seek their counsel when appropriate.

### **Common Mistakes**

Board meetings should be important forums in which critical issues for the company are discussed and decisions made. They often aren't. Here are a few of the common mistakes, I've seen and, on rare occasions, contributed to.

#### ***"Get the little things out of the way"***

I can't count the number of times that board meetings start off with a series of trivial subjects, so that "we can get them out of the way." More often than not, these "little things" consume the bulk of the meeting's time, and important things aren't addressed, or at least not adequately.

This is not to say that important "housekeeping" items shouldn't be dispensed with at the beginning of a board meeting. Assuming that you have distributed the material in advance, calling for the approval of the prior meeting's minutes; approval of corporate resolutions that had been discussed previously, and put into legal form between meetings; approval of stock option grants that the board authorized you to offer to a prospective



employee; and other similar things do need to be taken care of and can be dispensed with in a matter of a few minutes.

### ***Starting with detailed financial statements***

It is important to share the cash position of the company and how the company is performing against plan with the board. These can often be handled with two summary graphs or charts. If things are generally, “OK,” move on.

Too often the detailed financial statements are the focus of this discussion, and all of a sudden 30 minutes have gone by talking about things like, “Gee, your phone expense looks high. What carrier are you using? ... Well, we’re using ABC Phone Company and we got such a deal! You should check it out.”

That’s not what a board should be doing.

### ***No time discipline***

If you’ve selected the right board members, they are very busy people with many demands placed upon their time. If your board meeting is scheduled to last two hours, that’s what they have allotted for it. They will need to leave at that time, and you are showing disrespect if you don’t cover everything that you need to and/or try to get them to stay longer.

Set an agenda, including time benchmarks, and stick to it.

### ***No call to action***

The reason that the members of your board have joined is because they want to help your business and believe that they can make contributions to it. Yet, many board meetings end with everyone having had a pleasant time, lots of information and experiences exchanged, but nothing substantive has occurred.

You should always have one or two substantive topics on your agenda. It’s often a good idea to have an advance schedule of functional departmental reviews over the course of a year, normally one per meeting.

Sequencing through areas like sales, marketing, engineering, and operations, permits considered reviews of:

- What is the department doing today?
- Is that appropriate and adequate to meet the company’s current needs?
- What will be the future needs of the company?
- Is this department on track to meet those future needs?

Make sure you ask your board for their assistance in key areas and you will be surprised by what they can contribute.

## **Advice to entrepreneurs**

- Use your board as an asset.
- Schedule board meetings well in advance and etch those times and dates in stone.
- Communicate frequently and within a timely manner with your board members.
  - Get the board pack to them at least a week in advance.
  - Include YOUR (don’t let the finance person write it) transmittal letter that summarizes the progress of the company, and frames the upcoming board meeting by introducing the topics you believe are most important to discuss, and include an agenda that reflects the relative importance of the topics.



- Talk to each of your board members, by phone, at least twice between board meetings.
  - One time within a week after the board meeting to debrief the board member.
  - One time after you've drafted your transmittal letter and agenda, but before you have distributed the board pack, to solicit each board member's recommendations.
  - As often and as quickly as possible when "surprises" are imminent, or have occurred.
- Treat your board members with the respect that they deserve and they will respond in kind.



## Chapter 26

### Vesting Founder Shares: Founder “Fairness”

*By Frank Demmler*

I’ve given you two weeks to digest my admonition that, “Not all founders are created equal,” and that inequality needs to be reflected in the distribution of the founders’ equity pie.

Many of you are already in business and perhaps are living with the consequences of having taken the Three Musketeers approach to share distribution. Others have ignored my advice because it still doesn’t strike you as “fair.” Others, still, “got it,” but aren’t comfortable initiating what is likely to be a confrontational discussion, i.e., “What do you mean that you deserve more shares than me?!?!?”

Do not despair, there are remedies, although they need to be crafted carefully, and will require legal assistance to make them effective and enforceable.

#### **Founder Share Buyback Agreement**

The most frequently used method to address equitable division of the equity among founders, particularly if not addressed at the founding of the company, is to make the founders’ shares subject to buyback by the company.

Before I discuss the mechanics, let me clarify what this means. You know those shares of stock you got when the company was founded? Remember the sense of pride? Guess what? You don’t really own them, if this mechanism is utilized!

“Wait a minute! You’re telling me that the shares that I own outright today, I’m not going to own outright if I follow this suggestion?”

Yep.

“Why would I agree to that?”

If you accept an investment from a venture capitalist, you will agree because it will be an integral part of the deal.

If you remain a private company, you will agree to this provision, because I’m going to try to convince you as to why it’s “fair.”

#### ***What is it?***

A founder share buyback agreement is like vesting for stock options. Based upon some defined schedule and conditions, the company has the right to buyback some, or all, of your shares. Usually the buyback provisions will expire over time, meaning that as time passes the number of shares subject to buyback declines (and the number of shares you own outright increases).

For example, in many of the deals in which I’ve participated, it has been fairly typical for the founders to own 25% of their shares outright at the initial closing, with 75% being subject to buyback. After the first anniversary of the closing, the buyback will expire on a monthly basis on one/thirty-sixth of the remaining shares for the following three years (36 months). After four years, none of the shares are subject to buyback (one year plus 36 months of buyback expiration).

The primary elements of the buyback agreement are:

#### **Initial share rights**



What portion, if any, of the shares are owned outright at closing (25% in the example above). Some deals are structured so that no shares are owned outright until the first anniversary, at which time some percentage will no longer be subject to buyback.

### **The term**

This is often consistent with the company's stock option vesting schedule, if there is one, but not necessarily so.

### **The vesting schedule**

In the example, it's one/thirty-sixth per month starting after one year, for a total of four years. There is nothing magical about four years. It might be three years, or five years, for that matter. It depends upon the specific circumstances of your situation; who benefits from shorter or longer; and the relative power of the participants structuring the agreement.

### **Cliff vesting**

Cliff vesting is the situation in which the time between expiration events occur is relatively long and the amounts of stock are relatively large. For example, it would be cliff vesting if your deal said the buyback provision expired on 25% of your stock per year on the first through fourth anniversaries of the initial closing. While both examples would allow you to own all of your stock outright after four years, the difference between one/thirty-sixth per month and one-fourth per year is significant.

### ***Why go through all this trouble?***

In most cases, founders stock is actually intended to compensate the founders for what they did do to launch the company; what they are doing now for the company; AND what they are going to contribute in the future.

You may not have thought of it in that context, but let's say you started your company with your best friend and you split the stock 50-50. After three months, your partner comes to you and says, "This is a lot harder than I thought. I'm going to get a regular job. Lots of luck! I wish you well."

Oops! He's owns one-half of the company, and he just walked out leaving you high and dry. Is that "fair"? I don't think so.

Similarly, an investor is betting on the founding team's ability to build the business and achieve a liquidity event. Their explanation for the buyback agreement will go something like, "If for some reason you were to leave the company, you wouldn't have held up your part of the bargain, so you shouldn't own all that stock after you leave while your co-founders are still in the trenches earning their stock. In addition, we would have to go out and recruit a replacement for you. That replacement will be assuming the important functions that you currently perform. As such, we will have to make a significant equity commitment to that person. This is only 'fair.'"

### **Founders on the sideline**

This also highlights the problems of splitting the founders' pie equally when not everyone is participating in the business full time. That may be "fair" for what has happened to date, and the relative contributions of the people involved, but it often doesn't take future contributions into consideration.

If one founder is working at the business full time 24/7, constantly concerned about the company's fragile state, worried about paying bills and employees, sacrificing his family



life, foregoing salary (or taking greatly reduced compensation), it will not be too long when this “fair” stuff begins to look a lot different.

Since the non-participating founder’s stock isn’t subject to buyback, the primary way to bridge this “fairness” gap is through granting a meaningful number of stock options.

These can vest over time, as above, but at least can go a long way to leveling the playing field.

### **Advice to entrepreneurs**

- Founder share buyback agreements should be considered when you are starting your business.
- “Fairness” must be viewed in a broader context than the here and now.
- It is critical to think through these issues in the early days (ideally before launch) while rational minds prevail. When the issues that make these considerations important arise, it’s likely that the emotional quotient of the discussion will overwhelm rational portion.
- Surround yourself with professionals, mentors, and advisors who have “been there, done that” and can help you level the playing field.



## Chapter 27

### The Conundrum of Convertible Notes

*By Frank Demmler*

In this chapter, for the first time since I began this series, I am going to express an opinion with which I know many of you, both first-time entrepreneurs and investors, are going to disagree.

**Except in very special circumstances, I do not like convertible notes as an investment vehicle.**

#### **Rationale for a Convertible Note**

You've started your company and have done a great job of bootstrapping it so far. You've been able to convince some friends and business associates to join you, or to work nights and weekends, so that your product is really beginning to take shape. You know that it will just take a little bit more effort to do those things that will attract an investment from a venture capitalist.

BUT, you need just a modest amount of money to make it from here to there [hence, the term, "bridge loan"].

You get linked up with some angel investors and they get excited about you, your company, and its investment return potential. At that point the conversation usually goes something like this.

You: "Your modest investment will help me get to the point where venture capitalists will want to invest and then it's all downhill from there."

Angel: "You've convinced me. What did you have in mind?"

You: "We need to put together a convertible note with a premium for you for coming in now. That's what all the companies at this stage do."

Angel: "I'm not sure I get it. Please explain."

You: "Once we have done the things that your money will enable us to do [gotten a customer, completed an alpha or beta test, attracted someone to the management team], the VC is going to want to invest. Since we can't really value the company today, we'll let the professional investor establish the value when he invests. In exchange for you coming in now, though, I will offer you a sweetener so that you will buy your stock in that round at a discount to the price the VC pays.

"By making it a note, if something were to go wrong, but nothing will, but if something did, your note will be higher in the pecking order for repayment than stock.

"Besides, if we tried to value the company today, the VC would probably use that value against us when we negotiate his round. I'm just looking out for you so that you're treated fairly."

Angel: "Gee, thanks. Who do I make the check out to? What do I need to sign?"

As I've done before in this series, I've taken some poetic license, but it's not too far from the truth. The logic appears to make sense. In many cases, both sides think that they've done the right thing and that it's onward and upward.



## **Standard features of a convertible note**

A convertible note is a loan to the company, with an interest rate, that the investor has the right to convert the entire principal amount of the note (and often any accrued interest) into equity when an institutional investor subsequently makes an investment. Usually there is a premium for investing at this time. More specifically:

### ***Principal Amount***

This is the amount that the company is “borrowing” from the investors. In most circumstances, each investor will have an identical note with only the names of the note holder and the amount of the note being different. For example, a round of \$100,000 might be shared by five investors investing \$40,000, \$25,000, \$15,000, \$10,000 and \$10,000, respectively. Sometimes, a limited partnership, or its equivalent is formed; the investors invest in that; and then the LP becomes a single investor in the company.

### ***Interest Rate***

In my recent experience, annual interest rates on these loans are usually in the 6% - 10% range.

### ***Risk Premium***

In exchange for investing now, the investor is given additional consideration that effectively lowers his price per share as compared to the price paid by the subsequent investor. Often a specified discount in the range of 15-40% is used depending upon lots of circumstances. This number may be fixed or may increase over time. An alternative would be to issue warrants based upon an agreed to formula.

### ***Repayment Terms***

The convertible note is done with the presumption that it will, in fact, be converted. If it isn't, then the method of repayment must be defined.

Further, your private investor is doing this deal for the thrill of potentially making a lot of money. As such there will be restrictions, or prohibitions, related to prepayment.

The interest may be treated in several ways. You may want to have the interest accrue so that it doesn't impact your cash flow. That may be agreeable to the investor if the accrued interest will convert with the principal. Alternatively, you may want to pay the interest quarterly to avoid the additional dilution that would occur with it accruing and converting. Having current income from the investment may be desirable to your investors as well.

### ***Qualifying Transaction***

You have solicited this investment with the explanation that it will enable you to attract a significant investment on favorable terms. The investor will want to define what that means. Not that you would, but the investor doesn't want your Uncle Charley to invest \$1,000 at \$10 per share, and have that cause his loan to be converted as well. Usually, there needs to be at least a minimum amount raised before the conversion would occur.

### ***Protective Provisions***

As in any such security transaction [and a loan of this type is a security and must comply with the relevant securities laws], the investors will have certain protective provisions. Usually, certain transactions will require a majority approval of the note holders for such things as taking out loans above a certain amount, selling some or all of the important assets of the company, creating a new security that is senior to theirs, and the like.



***Maturity Date***

This is the date upon which your investor can seek repayment of the note. Depending upon circumstances, this might be as short as 30 days or could stretch over several years.

***Default & Remedies***

If your investor requests to be repaid per the terms of the agreement, and the company is unable, or unwilling, to make that payment, then your investor will have certain rights that he can invoke through the judicial system.

**Potential flaws of a convertible note**

While this may all sound reasonable, the consequences may not be.

***Operating objectives won't be met on time***

Nine times out of ten (actually more), a first-time entrepreneur will not achieve the operating objectives on a timely basis.

The consequence of this is more money will be needed, and guess who is the only likely source of that money? Look in the mirror.

***Achieving operating objectives doesn't attract investment***

Even if the operating objectives are achieved, there's no guarantee that an investor will be ready and willing to invest.

The consequence of this is more money will be needed, and guess who is the only likely source of that money? Look in the mirror.

***Institutional investors may not honor the terms of the note***

Even if you hit your operating objectives and attract an investor to the bargaining table, there's no guarantee that he will abide by the terms of your notes. If you only have one investor at the table, and you're running out of cash [which are both highly likely if you get this far], the Golden Rule will prevail: He who has the gold rules.

If a new investor agrees to invest only on the condition that the convertible note holders waive some, or all, of their rights, your original investors are between a rock and a hard place. They are faced with the decision of giving up all those financial benefits that you had promised them, coming up with additional money themselves, or let the company crater. Remember, a legal agreement is only the default if parties can't negotiate an alternative agreement. In this example, the potential investor can choose not to accept the default, and just walk from the deal.

***Institutional investors will probably ignore your valuation as a frame of reference***

The premise that not valuing a round today will induce a higher value later is based upon a flawed premise. An institutional investor will establish what he believes to be the company's value at the time of the investment consideration. Valuations of prior rounds, if any, may serve as points of reference, but will not be major determinants of the company's current valuation.

This is particularly true in today's funding environment and applies to all new rounds, not just those funded by angels.

***The downside protections aren't really fair***

If it gets to the point where the maturity date of the note comes and goes, it's highly unlikely that will be because the company is so prosperous. More than likely, you have not been able to raise the follow on round of investment. As a result, it's highly unlikely that you will be able to repay the notes when requested to do so. Further, the default



provisions and remedies won't yield much. You've heard the saying, "You can't get blood from a stone"? Well, you can't get cash out of a close-to-bankrupt company.

### ***Counterintuitive investment incentives***

Quite often, a first-time entrepreneur pitches the convertible note structure so long and so hard, that he begins to believe that the follow on investment by the institutional investor is inevitable. After all, the convertible note is a "bridge" from here to there. That mind set can be very dangerous. The discipline of controlling cash flow can get lax.

Another unintended consequence of this structure is that the institutional investors will have a disincentive to come to the bargaining table. Even if you do everything that you say you will do, you are still going to be an early stage company with lots of risks. The seasoned investor knows that when a first-time entrepreneur raises angel money, it is highly likely that the angels will pony up more money if there are no other alternatives. The investor knows that if he sits on the sidelines, you will further reduce risk with someone else's money and that the Golden Rule is still likely to be in effect when he comes to the table.

### **Appropriate Use of Convertible Notes**

I opened by saying that I didn't like convertible notes except in specific circumstances. Since I've slammed them so hard, I owe it to you to give you my opinion as to when they are appropriate.

I believe that they are absolutely the right vehicle for economic development organizations such as InnovationWorks, Idea Foundry, the Pittsburgh Digital Greenhouse, and the Pittsburgh Life Sciences Greenhouse. If their early funding launches a great success, then by all means, they deserve to participate on the upside. I know for a fact that if current policies had been employed by InnovationWorks' predecessor organization when Sean McDonald launched Automated Healthcare, the return on its investment would have been staggering on a relative basis, and awfully darn good on an absolute basis.

I also believe that convertible notes are appropriate investment vehicles for companies that have already raised money at a fixed price and all of the current investors are willing to take their pro rate share of the round.

### **Advice to entrepreneurs**

- Think long and hard as to whether a convertible note is really the best way to structure a round of financing, even if it's possible to do so.
- A convertible note just delays the resolution of a fundamental difference of opinion about valuation. The passage of time and intervening events are likely to exacerbate those differences, not resolve them.
- While likely to be painful for all involved parties, it is my sincere opinion that pricing the round, putting that issue behind you, and building value from that point forward will prove to be best for everyone.
- Surround yourself with professionals, mentors, and advisors who have "been there, done that" and can help you level the playing field.



## **Chapter 28**

### **Sources of Money (A): From within the Company**

*By Frank Demmler*

At the beginning of this collection, I jumped right into the discussion of issues between a first-time entrepreneur and an investor. As the weeks have passed, I have often pointed out some of the possible consequences of accepting different forms of equity investment from a variety of sources.

In the coming weeks, I will take a step back and examine the whole spectrum of money sources, of which equity investment is but one.

There are two sources of money: from within the company and from outside the company.

It often surprises me that first-time entrepreneurs rarely examine the company for its ability to generate cash.

#### **Gross Margin**

The most obvious, and best, source of funding is, without a doubt, gross margin – the difference between your selling price and what it takes to build that product or provide that service. You need to charge as high a price as you possibly can. In fact, in my experience, you should be charging 25% - 50%, or more, than your current prices. You've said to yourself, "He's out of his mind! If I raised my prices that much, no would buy from me."

If that were really true, then I would question the viability of your business. Fortunately, though it's not true.

You really believe in what you're doing, don't you? You are providing a product or service that uniquely provides your customers with value, aren't you? [Even if you hesitate on that one, YOU are a unique resource that is bringing that value, so it is true.] For most of you, you don't need thousands of customers in the first year. For many of you, if you were to get 3-5 customers, you would consider that a success. For the sake of argument, in the latter case, that means you probably have to identify less than 30 potential customers from which you garner those initial sales. With a little bit of effort, I know you can identify 30 potential customers for whom you provide a "gotta have" solution that will support premium pricing.

#### **Vendor and Customer Terms and Conditions**

Vendor and customer terms and conditions are another potential source of cash. If you don't push in this area, you are probably looking at paying cash in advance to your vendors because you have a young company without a credit history. You will bill your customers and expect payment in 30 days, but not get it for 45, 60, or maybe even 90 days. The person responsible for payables at your customer knows that you wouldn't dare threaten one of your only customers with a collection action.

So, from the time you purchase material from your vendor, receive it, put it into raw materials inventory, release it from inventory, process it in part or in whole, and place it back into inventory, as work-in-process or finished goods inventory, receive a customer



order, ship the product, invoice for the product, and get paid, it could be 180 days between when you spend a dollar with your vendor and when you get a dollar from your customer.

That's the case if you accept the status quo, and many of you do. You know you're an early stage company. You don't want to risk angering either your vendor or your customer. So, you think, it's better to keep your mouth shut.

I beg to differ. You are a great company that is in stealth mode. Your vendors and customers are fortunate to have you dealing with them.

With those thoughts in mind, you go to your vendor and explain that you are a young company, and cash flow is tight at the moment, so you'd like to accept the vendor's goods on consignment. You promise to pay as soon as your customer pays you. You explain that as you achieve success, you will remain faithful to those who help you in the early days. You point out that that could mean a very significant amount of future business. If the owner of your vendor is also an entrepreneur, you play that card, too.

You go to your customer with a similar pitch. Since they've already agreed to buy from you (at very high gross margins for you, see above), they appreciate and value your solution. That being the case, you explain to them that you're an early stage business with cash flow challenges, and therefore you need 50% of the purchase price at the time of the order. You promise to smother them with service and to always give them a preferred position in future dealings.

An alternative to that is to quote your customer a very high price, but agree to discount it 30% or 50% or 70%, as the situation dictates, if the customer pays in advance. That lets the purchasing agent look good to his boss ("Look at the money I saved us with my superb negotiating skills!"), and you get your cash now.

By the way, that high price is calculated by taking the amount of cash you need and grossing that up so that you can offer the appropriate discount. Since you are an early stage business and essentially every shipment at this stage is to one degree or another, customized, you need not be overly concerned that the bid to this customer bears no relationship to a bid, or even transaction, with another customer. You are providing a unique solution to their problem for which price is a minor issue.

If you were successful in getting both your vendors and customers to agree to these terms, you would accelerate your cash flow more than 180 days. You would have positive cash flow from day one because you will get cash from you customers BEFORE you need to pay your vendors. This could be an extraordinary amount of cash (or alternatively, the avoidance of raising cash through equity).

[Note: I believe I read an article several years ago that claimed Dell Computer made most of its money investing the float it created by charging its customers' credit cards at the time of order and through just-in-time inventory, paying its vendors sometime after that.]

## **Balance Sheet management**

In the short term, you may be able to manage the components of your balance sheet to squeeze some cash out. This should only be done with advanced planning and with a compelling need to do so. This is your classic, "Robbing Peter, to pay Paul" situation. You can delay paying your bills, loans, rent, etc., but only for a short period of time. If you have a large customer receipt due (and you're 100% sure you are going to get it),



then this is relatively easily done, particularly if you give the people to whom you owe the money a “heads up.”

On the other hand, if you are in a fragile cash position, you should talk to the people to whom you owe the money and try to work out some alternative arrangement. Your lender may accept “interest only” on the loan for some period of time. Your landlord may be willing to accrue your rent for a number of months. Your vendors may agree to some sort of payment schedule, or a willingness to give you a discount for immediate payment.

In any of the cases in which you have made commitments with your creditors, it is essential that you abide by them. In most cases, they will be willing to work with you as long as you’re up front with them. By the same token, if you prove to be distrustful or unreliable, they are likely to come down on you like a two-ton brick.

### **NB: Special Note about Payroll Taxes**

Do not play around with the money you’ve withheld from your employees’ pay. That is not your money. It is the government’s. You are only holding it for them. If you ignore this advice, officers with badges and guns can come and shut you down.

### **Advice to entrepreneurs**

- Your company and its operations can be an important source of cash for your business.
- Gross margins are good. High gross margins are better.
- Don’t accept the status quo. Try to get modified terms and conditions from your vendors and customers. If you don’t ask, you’ll never know.
- Within finite limits, you can squeeze short term cash by slowing down your payments.
- Your creditors will work with you, if you’re up front with them. Do not betray that trust.
- DO NOT PLAY AROUND WITH WITHHELD PAYROLL TAXES.
- Surround yourself with professionals, mentors, and advisors who have “been there, done that” and can help you level the playing field.



## Chapter 29

### Sources of Money (B): From Outside the Company

*By Frank Demmler*

Last week I presented the proposition that there are two sources of money: from within the company and from outside the company. Having discussed the sources from within the company, this week we'll look at the outside-the-company sources: loans, governmental programs, and investment.

#### Loans

Loans are a possible source of money, but are not likely to be available to a pure start up. First, all loan programs have requirements that start-ups don't meet by definition. Second, loans require repayment from the cash flow of the company. This is the very same cash flow that we have discussed in the past that is usually running negative during a company's early stages, so loans, and their required payments, could injure the company, not help it.

**Conventional bank debt** is rarely available for early stage businesses. The typical requirements are:

- 12 months of profitable operations
- Adequate collateral to secure the loan
- Personal guarantee

The primary workaround, with which I'm familiar, is a loan guarantee from high net worth individual

**SBA Loans** are most often loans from a bank, with some level of SBA guarantee (60-85%). I believe that the maximum guarantee amount is \$500,000, depending on the program, although that may have changed.

The key thing to realize is that these programs are for loans that almost, but don't quite, qualify for conventional bank debt.

**Economic development loan programs** focus on job creation and job retention. In most cases, the debt capacity is tied to jobs created or retained by the end of the third year. These programs require bank participation, to the preceding requirements come into play, with some latitude.

The most important component of these programs, from a financing qualification perspective is that the economic development agency will subordinate its debt to the lending institution, thereby increasing the availability of collateral to the bank.

#### Governmental Funding Programs

Many people mistakenly call such programs "grants". While grants may exist in particular circumstances, the most well known programs are not among them.

In my experience, two classes of programs exist for early stage companies to consider, federal and local programs. There are state programs, but many of them flow through local agencies, and/or the local agencies are likely to introduce you to those that are managed centrally.



## Federal Programs

The most well known of the Federal Programs is [the Small Business Innovation Research \(SBIR\) Program](#). Others include the Small Business Technology Transfer Research (STTR) Program and the Advanced Technology Program (ATP) sponsored by DARPA, I believe.

Federal programs are typically comprised of three phases:

- Phase I - Feasibility study - up to \$100,000
- Phase II - Proof of Concept (Prototype) - up to \$750,000
- Phase III – commercialization

Federal program have a number of issues that you need to consider.

The good news is that any monies received for work on contracts received through this program do not need to be repaid. The sponsoring agency will typically have a royalty-free license for use of the technology, but that's it.

You have to be careful that the contract you pursue is aligned with your company's objectives. The fact that you can do something, does not mean that you should do it. My rule-of-thumb is that at least 60% of the funding be devoted to infrastructure that you need in any case.

One of the risks of such contracts is that they will increase your burn rate, often in the addition of technical talent. If the core business has not advanced to the point of generating sufficient cash itself, or being able to attract outside capital, more often than not, the company becomes a “funding program junkie.” i.e., the focus of the organization becomes one of covering payroll from any funding source that can be accessed. Once this shift in focus occurs, I don't think I've ever seen such a company recover its entrepreneurial culture and vision.

We are fortunate to have at least three local resources to help companies navigate these processes:

- [Paul Petrovich](#) at the [Pitt Small Business Development Center](#)
- [Tim Deis](#) at [Catalyst Connection](#)
- Periodic workshops by the [Pittsburgh Life Sciences Greenhouse](#) (obviously with a life sciences focus)

## Local Programs

We are fortunate to have several local organizations that can supply both capital and assistance to early stage companies. All of these are primarily focused on technology-based efforts with each of the Greenhouses have an even narrower focus.

### ***InnovationWorks***

[InnovationWorks](#) is one of four center throughout Pennsylvania supported by the Commonwealth's Ben Franklin Partnership Program. Begun in 1983, this program was one of the pioneers in state-supported economic development focused on the creation of technology-based companies.

InnovationWorks has a number of funding programs that most often fall in the \$100,000 and \$300,000 categories. A single company, if it were successful in qualifying for each program available, could receive cumulative funding of \$1.1 million.

In addition, its staff of experienced professionals can help you determine if you qualify for their programs; assist you in applying for the programs; work with you as you deploy the funding; and assist in attracting follow on private sector funding.



***Idea Foundry***

[Idea Foundry](#) takes a very proactive role in assisting companies with high potential, but incomplete management teams and limited financial resources. Like all the other programs, core requirements must be met to receive initial funding of \$100,000. Idea Foundry works closely with the other organizations in the community to assist its “graduates” in achieving commercial success.

***Pittsburgh Digital Greenhouse***

The [Digital Greenhouse](#) was founded by the Commonwealth of Pennsylvania as a collaborative effort among the University of Pittsburgh, Pennsylvania State University, and Carnegie Mellon University to create the foundation from which a “System On a Chip” industry could emerge. Through the creation of funding programs for both university research and private sector participants attempting to commercialize their own technology, or that of a university, it is hoped that a critical mass of commercial activity will occur and put the Region on the map in this industry.

The efforts are complemented by the creation of educational curricula and the providing of classes that will train professionals, ranging from technicians to potential CTOs, in the industry. Also, industry membership efforts have successfully attracted companies to provide commercial guidance and assistance, and to make sure these efforts are meeting the needs of the emerging industry.

***Pittsburgh Life Sciences Greenhouse***

The success of the Digital Greenhouse was such that when the money from the tobacco settlement was received, Pennsylvania launched three Life Science Greenhouses modeled after the Digital Greenhouse. Our local organization is the [Pittsburgh Life Sciences Greenhouse](#) (PLSG).

PLSG has a number of funding programs ranging from early stage technology development funds through a seed capital fund managed by PA Early Stage and a venture capital fund that will be managed by Birchmere Ventures when it closes.

**Investment**

Investment ranging from friends and family to institutional venture capital has been discussed in great depth in prior articles, so I won’t repeat them here.

What is important for you to realize is that there are several sources of funding that may be available to your efforts. Further, proactive pursuit of the proper and viable sources at the right time and with the right amount of effort can significantly enhance not only your chances of attracting funding in the near term, but will position you to successfully attract the follow on funding that you will need as your company enters commercialization.

Remember, attracting investment is a function of perceived risk and potential reward. The successful attraction of funding from these programs is likely to have a major positive impact on your institutional investment attraction. The third party confirmation of your business will help. The fact that you can advance the technology of the business with these sources of capital reduces the technical risk and the financial risk. In some cases these programs can be bundled with investment so that all parties can benefit.

**Advice to entrepreneurs**

- Take the time to learn about and understand the various financial resources that are potentially available to you.



- Meet with the professionals associated with each of the programs to build your knowledge and expand your network. Try to do this well in advance of when you will be trying to get funding so that you already have a coach and an internal advocate within that organization.
- Talk to people who have successfully raised money from these various sources. They either had assistance, or wish they had, and will be very empathetic to your quest.
  - You should know some of these people already, but you probably don't, so this will give you the reason to do something that you know that you should have done already.
  - By virtue of the fact that they have successfully raised money from these sources, means that they are likely six-to-24 months ahead of you in the "building a business" process. Perhaps you can draft them to mentor you.
- Surround yourself with professionals, mentors, and advisors who have "been there, done that" and can help you level the playing field.



## Chapter 30

# Sources of Funds by Phase of the Start Up: Raising Money for New and Emerging Companies

*By Frank Demmler*

The purpose of this article is to explain what money resources are realistically available and when they are available during the evolution of a firm. We hope they help you in planning and structuring a business and increase the likelihood of your success.

To understand how **Raising Money** relates to the evolution of a new business, six key factors are important to understand.

1. This article focuses on embryonic businesses or ventures, prior to the time they have established an economically viable product with attractive markets, an attack plan that can be replicated, and a management team that can carry out the attack plan.
2. Ventures typically pass through developmental phases before they become commercially viable and successful firms.
3. The long time it typically takes for a venture to evolve affects the availability of funds.
4. As ventures evolve, the cash resources needed increase significantly with each phase.
5. Uncertainty must be resolved at each phase, since greater funds are needed for each step. An investor is making a subjective decision based upon perception of risk and reward.
6. The availability of different sources of capital, primarily debt or equity, depends on the developmental phase of the enterprise and its probability of successful commercialization.

### **Background: Life Cycle of a Business**

All industries, businesses, and products pass through the four stages of a life cycle: **Embryonic, Growth, Maturity, and Decline**. What changes from business-to-business is the magnitude of the sales and the time for each. The dot.com boom and bust was short. Table salt is at the other extreme.

The focus of this article is the embryonic stage of the business life cycle and the sources of money that are available to firms in this stage of growth.

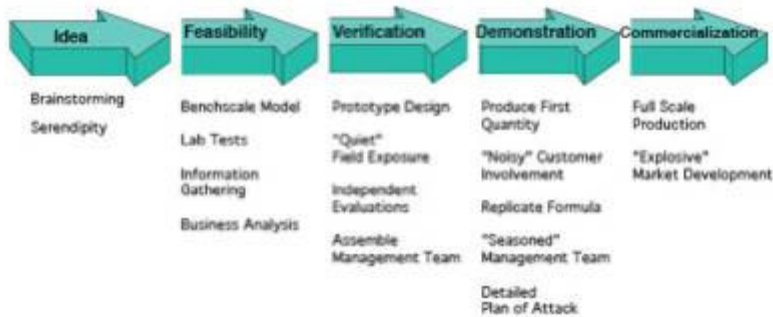
### **Purpose of the Embryonic Stage**

The purpose of this stage is to evolve a business to a point where it has three key elements that will spell success: (1) An economically viable product or service with attractive markets; (2) an established plan of attack that can be replicated; and (3) a seasoned management team that has demonstrated that it can carry out the attack plan.

### **Phases within the Embryonic Stage**

The embryonic stage can be broken down into five identifiable, developmental phases: **Idea, feasibility, verification, demonstration, and commercialization**.





The **idea** phase is the creative step where the business concept is established.

The business idea can come from brainstorming, for example, speculating on how the application of a technology can better fill customers' needs. Some successful businesses are the result of serendipity or the accidental discovery of a desirable product or service. The idea is then researched and tested on a very limited scale in the **feasibility** phase. The primary question to be answered in this phase is: *Does it work?* A breadboard or laboratory model is generally constructed, and it may be tested with one customer under controlled conditions. A service would be structured and tested on a pilot basis with one customer. Market research using secondary sources and initial evaluations of the business economics are performed to assure the attractiveness of continued investment of time and money.

In the **verification** phase, the prototype service or pilot models are "quietly" field-tested. The primary question to be answered at this phase is: *"Now that we know that it works, does anyone in the marketplace care?"* This is the first commercial exposure to customers, but the exposure is purposely limited to allow time to improve the performance of the product or service. A key objective is to gain an in-depth understanding of the customer's needs and how the product or service may be modified to better meet their needs. During this phase, the venture begins to evolve into a business, and key people are added to build the management team.

In the **demonstration** phase, the firm begins to scale up its operations to prove that it has a business formula that can be replicated for success. The product is refined for efficient, low cost production, and pre-production lot sizes are produced to show that consistent, acceptable units can be produced. An established selling approach is applied to a broader set of customers, such as those in a wider geographical area. The key management team demonstrates that it has the ability to implement a plan that can address a wider, possibly national market.

In the **commercialization** phase, major investments are made to achieve efficient, low-cost, full-scale production and for full-scale market development. For some firms, the investment in manufacturing plant and equipment can be many millions of dollars. The investment to introduce the product or service to a wide set of potential customers, such as spending for advertising or to build a national sales force, can often be more than spending needed for manufacturing facilities. This is especially true for service businesses or for computer software firms.

### Time to Pass Through the Embryonic Stage

Many first-time underestimate the time it takes to build a business from the idea phase to the point where success or failure in the commercialization phase is clear. A study of 120



ventures showed an average time of 8 years to reach positive cash flow and evolve from the idea phase to the commercialization phase. *[While I vaguely remember that there was such a study, I have no recollection of its source.]* Others estimate the average time to profitability from 6-14 years.

Of course, there are exceptions to this average, and the exceptions are often the most publicized. Buying a franchise can have great appeal because it greatly reduces the time to commercialization by eliminating the **idea** and **feasibility** phases and shortening **verification** and **demonstration** phases. Someone else has already done the pioneering work.

The time needed by an individual firm to pass through the embryonic phase is an important factor that influences the amount and kind of money that a firm can seek.

### **Cash Needs Increase for Each Phase**

The cash needs of a venture increase with each phase. The stakes go up to play in the next phase, and the costs of failure or exiting from a phase also increase.

One rule of thumb is that the cash needs for each phase increase by a factor of 5 to 10. By far, the most expensive step in the process is the commercialization phase.

For example:

- \$1 is needed to establish an idea;
- \$10 is needed to prove that it is feasible;
- \$100 is needed to verify that it works in the field and that it really fulfills customers' needs;
- \$1,000 is needed to demonstrate that the product can be produced efficiently, that a marketing and selling formula is successful, and that the management team is effective;
- \$10,000 is needed to produce the product in full-scale volumes and to develop a national marketing and sales campaign and organization.

### **Each Phase Should Reduce Uncertainty**

Each developmental phase should reduce uncertainty or risk; each phase should increase the probability of success of the venture.

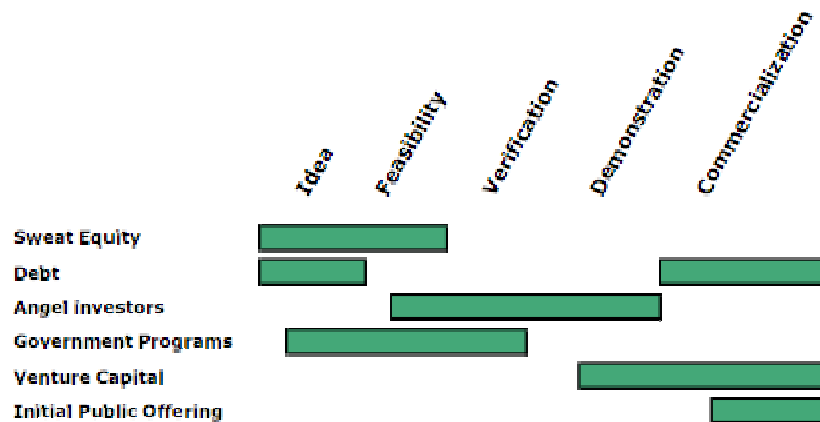
All decisions to provide funds to a venture are tied to somewhat subjective risk and reward trade-offs. The higher the perceived uncertainty and risk, the fewer the sources of capital which will be available, and the higher the return demanded by investors who do participate. The lower the perceived uncertainty of successful commercialization becomes, the more accessible financing will be. Furthermore, investors are likely to demand less of a share in the company because the perceived market value of the firm will be greater. The process of moving a venture through the phases must reduce uncertainty and improve the probability of success.

The largest financial decision is the decision to invest for commercialization, and the phases before this decision point should have reduced the perceived uncertainty and risk to a relatively low level.



## Funding Sources and the Relation to the Phases

The major sources of funds for firms in the embryonic stage are:



**Debt** is generally not a major source of funds for ventures prior to the commercialization phase. An entrepreneur may obtain loans using personal savings or assets as collateral; other than this, debt is not a key source of funds for the feasibility, verification, or demonstration phases.

Lenders want low uncertainty of repayment and require collateral. Ventures do not develop assets such as accounts receivable, inventory, and manufacturing equipment, until they reach the demonstration or commercialization phases. Most government loan programs or loan guarantees are tied to the assets of the firm, mostly to bricks and mortar, and they still require the personal guarantee of key management.

**Capital from individuals** is often the key source of capital for most firms prior to the commercialization phase. This is particularly true for the cash needed for the feasibility and verification phases and for start-up firms that are not technology based and, therefore, cannot access federal, state, or local technology programs.

These funds are most often in the form of equity. Sweat equity is supplied from the entrepreneur's own cash from savings and monthly cash that is provided because the entrepreneur and others often take sub-standard wages during a venture's earliest phases. Equity can be raised by the entrepreneur's personal efforts to sell stock to a personal network of potential investors.

Suppliers or customers can be an important source of funds for a developing business. Vendors may provide extended terms, or even provide products on consignment. Customers may provide down payments or cash advances against future orders.

**Government programs** may be available for technology research and development during feasibility, verification, and demonstration phases.

**Venture capital** is a source of equity capital for start-up firms. However, while some venture capital firms specialize in very early stage funding, this is the exception rather than the rule.

Most often, venture capital is not available until the firm has reached the demonstration phase, and possibly not until the firm is ready for commercialization. Many venture capital firms want to invest where the time horizon is relatively short, since they must



liquidate their investments and provide cash return to their investors within a finite period of time. Less than 2% of the proposals reviewed by venture capital firms receive funding.

In certain cases, an alternative to venture capital is a **private placement**, in which the funds are raised by an investment banker for a fee.

Finally, if equity has been raised, a liquidity event must be provided to the investors. An **initial public offering** may be a desirable exit and an option for raising capital for a firm undergoing rapid expansion after the initial commercialization phase. A firm may need added equity to finance the rapid growth stage, or possibly the image of being a public company will add credibility to the firm with its potential customers.

Alternatively, a firm could be acquired in this phase. The acquirer may provide access to needed financial resources, as well as, provide marketing skills or production “know-how” to help in expansion.

## Summary

- Ventures pass through five phases: Idea, Feasibility, Verification, Demonstration, and Commercialization.
- The time to pass through these phases is longer than most believe -- typically many years.
- Cash resources needed increase at each phase. The investment for commercialization overwhelms all previous investments.
- Many ventures are weeded out as they progress. Uncertainty must be resolved in each phase.
- The sources of cash to sustain an embryonic business depend on the phase of development and the perceived risk and uncertainty of successful commercialization.



## Chapter 31

### To Get Big, You've Got to Think Small

*By Frank Demmler*

Let's return to one of the basic themes of this series: Risk vs. Reward.

As a first-time entrepreneur, you must be able to look at yourself and your business from the perspective of those from whom you want assistance, particularly investors. You've read the business planning books, and you know that you need to develop a plan that shows that you can become a big business. In your mind,

**big business = big market**

which in turn leads you to build your plan around penetrating a market potential of hundreds of millions, or even billions, of dollars. Sound familiar?

With that premise, your business plan may contain a declaration that looks something like this:

**"By capturing 0.5% of the market, we will achieve our conservative sales forecasts. At the same time, we won't be on the radar screens of the major players and won't be subject to any competitive pressures."**

Red flags are raised! Alarm bells go off! Risk meter pegs out! Ding! Ding! Ding! Plan goes into the wastebasket!

That was quick (perhaps less than 20 seconds). What happened?

#### **Investor Requirement #1: You've got to know your market**

An investor will want to be comfortable that you understand the dynamics of your chosen market and that you can successfully build a business. How do you capture 0.5% of a market? If the investor were to provide you with the requested capital, what are the first three things you would do? Advertise? Hire a field sales force? How do you measure your progress?

The point I'm trying to make (and probably doing it poorly) is that a target of 0.5% market share tells an investor that you don't really understand your market. In addition, it doesn't give you the kind of focus that he knows you'll need to be successful.

All of this adds up to risk that in the opinion of the potential investor may be enough to reject the investment opportunity without going any further.

#### **Investor Requirement #2: You've got to have a practical business development strategy**

You do need to build a case that your overall market is of a significant size so that you have an opportunity to build that big business that investors seek. You need "sex and sizzle" to attract the attention of the sophisticated investor. But once you've done that, you have to think small to get big. Let me explain.

Your challenge at this point is to determine meaningful market segmentation parameters so that the overall market can be divided into *market segments*. Next you have to define the *niche* within that segment that you will successfully penetrate because the members of that niche have specific needs that you can uniquely satisfy.

Bear with me. I'll walk through an example that I think will help you "get" this.



### **Investor Requirement #3: You need a plan that you can execute**

As noted above, a target of a market share of 0.5% doesn't give you much help in conceiving of and developing a plan that you can execute. But, if you do a good job of identifying your niche, you can develop such a plan.

An investor will want you to be able to answer the following questions:

- Who are your immediate prospects, by name?
- Why is each likely to buy from you?
- What individuals in the prospect company will be involved in the purchase decision and what role will each play?
- How long will it take to receive a firm order?
- How many prospects will become customers in the first three, six, nine and twelve months?

You can answer these questions if you are focused on a niche. You can't if you're trying to get 0.5% of a market.

### **An Example: Automated Healthcare, Inc.**

Sean McDonald, founder and former CEO of Automated Healthcare and current CEO of Precision Therapeutics, taught me these lessons. When I think back on those early days of the company, I marvel at his audacity and wonder how the heck he ever convinced me to lead the investment in his company. In essence, Sean said, "I'm going to sell robots to hospitals for \$1 million," and I believed him!

In 1990 there were close to 8,000 hospitals in the United States (or so I recall, perhaps in error). That's a pretty well defined market, but not very useful. Of those, less than 1,000 had more than 400 beds, which meant that they were big enough to justify and use a robot. And so it went, until he had defined a universe of perhaps 25 hospitals that met the company's requirements. Among those requirements were:

- ☐ Hospitals in which the director of pharmacy was a significant player.
- ☐ Hospitals in which pharmacy directors would "get it" (the inherent benefits of automation and barcodes).
- ☐ Hospitals whose purchase of the AHI product would give the company credibility and would serve as references to other hospitals.

Of the company's first ten customers were four of the past five presidents of the American Hospital Pharmacy Association. Now, that's a niche! The company's success with this initial batch of customers provided the foundation from which a broader market segment could be accessed.

The company was sold to McKesson in 1996 for \$65 million, and I believe that McKesson Automation has over 800 hospital customers today.

*To get big, you have to think small.*

### **Summary**

- The identification of a large market is necessary to attract institutional investors.
- Identifying a niche is necessary to formulate an effective commercialization plan.
- You build your business one customer at a time.
- Initial customers need to enhance your ability to attract future customers.



## Chapter 32

# The Declarative Imperative: Generating Sales Quickly and Cheaply

*By Frank Demmler*

In the last chapter, I discussed how important it is for an entrepreneur to REALLY know his market. In terms of investment, the investor's perception of risk will be inversely proportional to his perception of your market expertise.

In addition to the topics in the prior article, a litmus test of your expertise is your ability to capture the essence of your business in a SINGLE DECLARATIVE SENTENCE.

99 out of 100 first-time entrepreneurs will respond that that's ridiculous, and impossible. 99 out of 100 entrepreneurs who have multiple starts up under their belts will admit that it's a challenge, but can be done, and is one of the most important exercises that an early stage business can undertake.

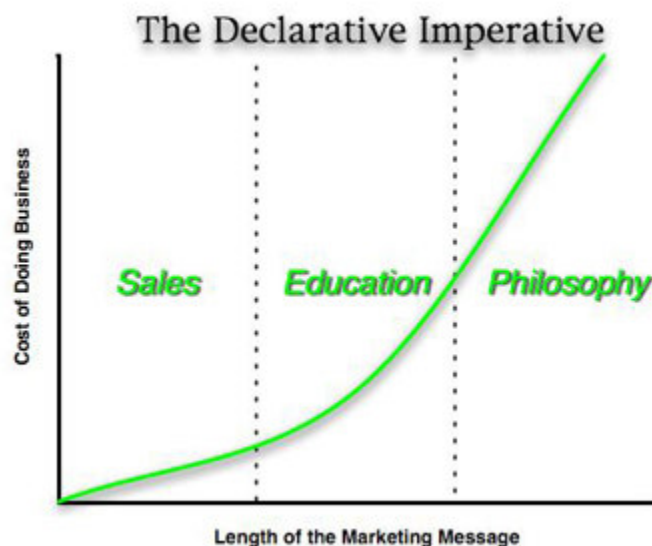
This concept, with many variations, is frequently found in books and articles about entrepreneurship. I call my particular flavor, The Declarative Imperative.

### First Product Introduction

An early stage business often underestimates the cost of marketing its first product. It often takes far more time, effort, and money than anticipated. An early stage company with cash constraints must create sales revenue quickly. Having an obvious and meaningful customer benefit, and being able to effectively communicate it, is essential to generating such sales.

#### *The Declarative Imperative*

An early stage company must be able to sell its product (or service) to a customer with one declarative sentence. The cost of selling increases dramatically with the length of a company's marketing message.





## Customer Interaction

Interaction with potential customers for an early stage business falls into three general categories: philosophy, education, and sales.

- The philosopher says, "Let me convince you why our approach is correct, regardless of how you currently operate."
- The educator, on the other hand, proposes to the potential customer, "Let me explain how my product or service works," often leaving it up to the customer to decide whether it has any applicability in his company.
- The salesman, though, says, "Buy my product or service to solve your problem."

Each approach may be appropriate under a given set of circumstances, but only the salesman is attempting to generate revenues.

## Challenges & Responses

What are some of the challenges for a start up company presented by the Declarative Imperative?

- Is the basic benefit to a customer simple and clear? While many subsidiary benefits may exist, is there an obvious one that cuts across all targeted customers?
- Can the benefit be quantified in a meaningful and effective way? Examples are increased sales, reduced cost of sales, higher production output, and reduced operating costs, either directly or through specific productivity improvements.
- Can you identify a segment of your anticipated customers who will immediately react to your proposed benefits more strongly than others? See the discussion of market niche in last week's article.

This line of reasoning leads to several suggestions for first-time entrepreneurs:

- Focus your initial product design to deliver a few basic, important features and benefits to ease the sales burden. Doing one thing that customers will immediately value is better than doing several things that complicates the message to your potential customers.
- Even with this conservative approach, you will still make mistakes. Do not over-commit to the initial product configuration (or service) or a single marketing/sales strategy until you have gotten clear market confirmation of each in terms of a growing revenue stream.
- If education appears to be unavoidable, devote a great deal of energy to creating and evaluating alternatives. Is there another way to "slice and dice" your market. Should you put the product on the back burner and use your technology to deliver a service? Should you mothball your company until the market catches up with you and your vision?
- Above all else, be patient until you are convinced in your "heart of hearts" that the time is right.



## Chapter 33

### The Most Frequent Source of Funding

*By Frank Demmler*

This past week I ran into Rich Ekstrom, CEO of Demegen, Inc., at the BioBlast gathering, and he brought up this series of articles in our conversation. My chest puffed up and I prepared to graciously accept his compliments. Instead, he lodged a complaint. He said, “You’ve overlooked the source of capital that I have used to fund each of my start ups, as has virtually every other entrepreneur I know - credit cards!” He added, “At one time I had 120 active credit cards!”

You know, he was right! I have mentioned in passing things like sweat equity, savings, foregone wages, and the like as being the entrepreneur’s contribution to launching his business, but I haven’t probably put sufficient emphasis on the role of personal debt, particularly credit cards.

#### **Some Background**

According to estimates of the Small Business Administration, in 2003 almost 573,000 firms with employees were started; almost 555,000 ceased operations; and a little more than 35,000 went bankrupt. Census data from the same period shows that there were 5.7 million businesses with employees. A Federal Reserve Board study in 1998 showed that 82.5% of small firms used debt, with 34.1% using business credit cards, and 46.9% reporting the use of personal credit cards.

In the overall scheme of things, venture capital serves only a very small niche of the small business activity. 2,779 companies received venture capital investment in 2003 (Source: MoneyTree Survey by PricewaterhouseCoopers, Thomson Venture Economics and National Venture Capital Association), of which about half were first-time investments.

Bottom line: If you attract venture capital, you are in very elite company. Conversely, if you are going to start your business, it is extremely unlikely that you will receive venture capital, but it is very likely you are going to go deeply in personal debt to pursue your dream.

#### **Your Creditworthiness**

You are going to have to supply the initial funding to your company, by whatever means possible, and that almost always requires some degree of personal debt. If nothing else, it means that you’ve got to plan for that eventuality.

Let me share a story with you. I had a friend with a good job, a house, a family and entrepreneurial aspirations. One day he showed up at my office almost beside himself with anger. Once I got him settled down, I inquired as to the problem.

He replied, “I went to see my banker, and after all that I’ve done for him, he wouldn’t lend me \$50,000 to start my business.”

I interjected, “Whoa! Wait a minute here. You’ve always talked about starting a business, but I didn’t realize you had decided to do it. Take me back to the beginning.”



“Well, I just had my 35<sup>th</sup> birthday party and I realized I wasn’t getting any younger. You know that I’ve read books on small business, and every one of them says the older you get, the less likely you are to start a business,” he explained. “So, I got up the next morning, went in to work and quit. Then I went to the bank to get funding for my business. And the SOB said, ‘no.’”

“In fact, to add insult to injury, when he learned that I was starting a business, he converted my home equity line of credit into a term loan,” he continued.

Oops!

Let’s look at this from the banker’s perspective.

- A sold upstanding citizen with a job, good W-2 income, a house and family is a good credit risk.
- A person without a job and trying to start a business appears to be unemployed and a bad credit risk.

The former can borrow money within limits. The latter cannot.

### **It Gets Worse**

Not only do conventional sources of debt financing become unavailable to you, but also you will have to provide personal guarantees for any debt financing you are able to secure for your business. Pretty soon after you start your business, between actual debt and other guarantees, you will “owe your soul to the company store.” (Tennessee Ernie Ford, “Sixteen Tons”)

### **Advice to the Entrepreneur**

*Caveat: I am not an attorney. Don’t do the following without legal advice.*

- If you’ve got a job, keep it as long as you can and secure access to as much debt as possible.
  - If you own a house, establish a home equity line of credit.
  - Sign up for any credit card that doesn’t have an annual fee.
- When you quit your job, try to do all you can to make at least the minimum payments on any outstanding debt. You want to avoid bringing attention to yourself and have your lenders realize you are “unemployed” from their perspective. *Some of your loans may have a requirement to report any change in employment status, thus the legal caveat at the beginning of this section.*
- You cannot let the fear of bankruptcy influence your decisions.
- From a mental approach to your business, you’ve got two choices, depending upon your personality:
  - Refuse to accept bankruptcy (and any form of failure) as an option, or
  - Assume that bankruptcy is inevitable, so that every day that you’re not, is a good day.
- Have fun!



## Chapter 34

### Tales of Two Companies: Selling, Educating & Philosophizing

*By Frank Demmler*

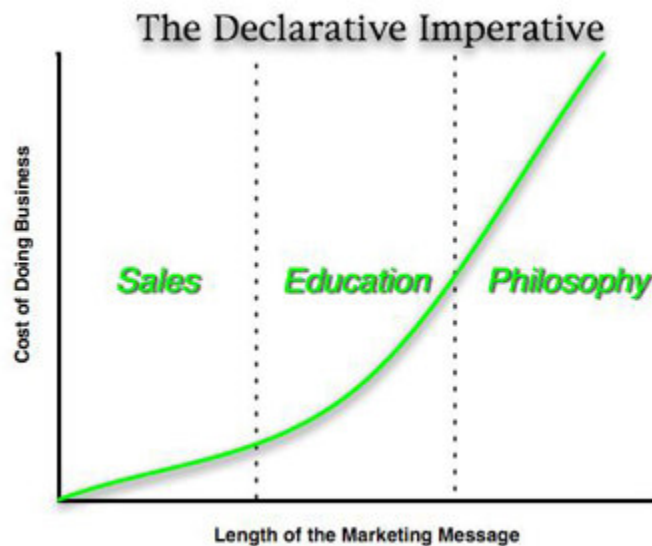
In this chapter I am going to return to the marketing theme by sharing my recollection of two local companies that were launched in the 1980s. It's said that you learn more from your mistakes than from your successes. From that perspective, I must be pretty well educated.

By the way, these are my interpretations of my memories about these companies. I present them for illustrative purposes. It's likely that there are factual errors, as well as different interpretations of these events by those who were involved.

Let's return to the concept introduced in a prior article: The Declarative Imperative.

#### The Declarative Imperative

An early stage company must be able to sell its product (or service) to a customer with one declarative sentence. The cost of selling increases dramatically with the length of a company's marketing message.



#### The Iconnex Philosophy

In the mid-1980s a British engineering society published a study that claimed that 85% of the life cycle costs of a product are committed within the first 5% of the design effort.

The basic premise of Iconnex was that making those initial efforts more efficient would be of tremendous value to companies.

The Iconnex product, the Mechanical Engineering Workbench (MEW), integrated a drawing window, an equation solver (based upon parametric modeling), a spreadsheet and a word processor. The elegance of the product was astounding. Each of the functions was relatively immature and the Iconnex integration was truly an amazing achievement. Some of the challenges that Iconnex overcame included the absence of a graphical user interface in the operating system (DOS 3.0, I believe), the 640K-memory limitation, primitive (and expensive) graphics cards and color monitors.



At the time, conventional engineering practices limited the typical mechanical engineer to two or three design iterations before a design commitment was made. The Iconnex MEW enabled the engineer to go through 10 or more design iterations in the same amount of time. The compelling logic of our value proposition, and the elegance of our product, with a market potential of 414,000 practicing mechanical engineers, convinced us that we had a real winner. Thought leaders in the industry agreed.

Further confirmation was provided by the fact that another company, Aries, I believe, had received over \$20 million of venture capital financing to develop a similar product, but on a mini-computer platform. The Aries cost per seat was going to be \$35,000. Ours was less than \$3,500.

Long story, short, the company consumed over \$6 million of cumulative venture capital financing (probably equivalent to about \$20 million in today's dollars) over several rounds; never figured out how to sell the product in sufficient volumes and with adequate predictability; and ultimately sold its source code for low six-figures.

The reason? **We were in the philosophy business.** We were telling people how they should do business. We were not responding to their "table pounding need" (I think I stole that phrase from Joel Adams to give credit where credit is due). We had to spend a lot of time, energy and money trying to convince people that we were right (and, by implication, that they were wrong).

Iconnex did not satisfy The Declarative Imperative.

### **The NeuralWare Sales Machine**

The most impressive example of accommodating The Declarative Imperative was conceived and implemented by the founders of NeuralWare.

NeuralWare was founded in the 1980s to take advantage of the confluence of factors that would allow the commercialization of neural networking technology. With Moore's Law proving to be a real phenomena, computing power was rapidly approaching the price and performance that would make this practical. The vision of the founders was to develop a line of neural network products that could work on desktop computers.

Even today neural networks are not broadly known, so you can guess what it was like in the 1980s!

What follows may be more myth than fact, but it's necessary context. In the late 1940s and early 1950s, as computers began to demonstrate their potential, two forms of artificial intelligence were conceived: expert systems and neural networks. Expert systems can be thought of as enormous decision trees that attempt to capture the variables and decision-making process of experts in certain domains. Neural networks mimic the learning process of the brain, recognizing patterns from within massive amounts of data and adjusting over time as it absorbs more and more data. Neural networks are used today in many applications including technical stock market analysis, credit card fraud detection, process control optimization and electronic fuel ignition.

As computing power and programming sophistication improved, expert systems first, and neural networks second, became technically and commercially feasible. The Carnegie Group, an early Carnegie Mellon spinout, was one of four, I believe, prominent artificial intelligence companies based upon expert systems that was launched in the mid-1980s.



Returning to NeuralWare after that brief history lesson, you might think that its marketing challenge was even greater than that of Iconnex and even more philosophical in its market entry, but it wasn't!

Why? Because the founders accepted certain realities and proceeded accordingly.

First, they didn't have the resources to develop a deliverable product.

Second, they didn't have the resources to mount a missionary sales and marketing campaign.

Third, while hundreds of thousands of engineers and programmers could use neural networks beneficially, by and large, they had no need to do so. They either didn't know about neural networks; or knew about them, but didn't know if they were applicable to their situation; and even if they were, how the heck did you build a neural network?!?! BUT out of those hundreds of thousands of potential users, there were hundreds of people in research labs, in IT departments and in university labs who were aware of the potential of neural networks. They did monitor the environment to keep track of advancements in the field. They did believe that it was only a matter of time before neural networks would be able to deliver very significant benefits.

For these few hundred people, knowing about neural networks was important. They had a need. To that end, **the first revenues for NeuralWare were from the sale of a bibliography** of all articles and publications on neural networking that the founders had compiled as part of their initial research before launching the company!

Instead of philosophizing to the people who could use neural networking technology, NeuralWare went to the very small and very specific market niche of individuals who were already believers and thirsting for information.

**The second revenue stream came from tuition for seminars** in Pittsburgh about neural networks that they marketed to the purchasers of the bibliography.

Most of the attendees from industry were at the seminars to assess the current or future applicability of neural networks within their companies. **NeuralWare offered to do feasibility studies for a fee.**

When the feasibility studies were completed, **NeuralWare offered to develop a customized neural network system for those companies who wished to pay NeuralWare for that service.**

Note the elegance of the company's evolution. It SOLD products and services to people who had already been qualified as NEEDING them. The customers for the current deliverable became the target market for the next deliverable.

In the meantime, customers were paying NeuralWare to build the infrastructure and IP that they needed to develop the neural networking products that were their ultimate vision.

They recognized the power of The Declarative Imperative and used it to formulate a successful market entry strategy.

NeuralWare went on to be acquired by a firm out of Boston. It's my understanding it has been taken private again and is still in operation in Pittsburgh. I regret that I haven't kept in touch with the founders (whom I believe are no longer with the company), but I am forever indebted to them for showing me a unique and innovative way to bring leading edge (bleeding edge?) technology to market.



## Advice to Entrepreneurs

- When you first start up your company, slice and dice your market opportunity until you can identify a group of specific customers who have an urgent current need for what only you can provide.
- Quite often going slowly at first is the best way to realize your ultimate dream.
- Heed The Declarative Imperative.

**ICONNEX POSTSCRIPT:** *The prior anecdotes about Iconnex were slanted somewhat for illustrative purposes. Out of respect to the founders, investors and employees of Iconnex, I need to note that it was a noble effort that almost made it.*

*At one time, a major aircraft company had decided to standardize on the MEW across the corporation. They were about to issue an initial purchase order for 100 units (at a modest discount to the \$3,500 unit price) and contract with Iconnex to develop client-server architecture. Between the credibility of this customer and the cash flow it would provide, this could have made the company.*

*As these agreements were working their way up the corporate ladder for approvals, elsewhere in the corporation, a decision was being made to decentralize purchasing, meaning there would not be any corporate-wide software standards. The 100-unit order by the corporation became a two-unit order by one division.*

*By the way, this is an example of Schwartz' Law. What, you've never heard of Schwartz' Law? Schwartz said that Murphy was an optimist!*

*Oh, yeah, I almost forgot.*

*Six months after Iconnex started, another company based upon parametric modeling was launched in Boston. Iconnex zigged. The other company zagged. That company was Parametric Technology and it has a current market capitalization of about \$1.4 billion. Damn that Schwartz!*



## Chapter 35

### The Founders' Pie Calculator

*By Frank Demmler*

Several weeks ago, we took a look at the founders' pie. I noted that frequently the founding team divides 100% by the number of founders.

I also cautioned that this is the WRONG WAY!

I then went on to identify the factors that should be considered when making these decisions.

Since then, I have had several people tell me that while what I wrote certainly made sense, it wasn't very helpful. They said that when it came to "rug cutting time," absent an alternative method, equal shares was the only method that seemed to be "fair."

As a public service, I have "invented" a Founders' Pie Calculator. As you will soon see, this calculator is not particularly profound. In fact, I'm sure I haven't "invented" it, but, at the same time, I have never seen it before. [Caution: perhaps there's a fatal flaw that I haven't considered.]

Its primary benefits are that it provides a way to quantify the elements of the decision making process, and that it appears to be logical and fair.

#### **Elements of the Decision Making Process**

Let's revisit the factors that should be considered.

##### ***Idea***

The company wouldn't exist if it weren't for the original idea, and that is certainly worth something, BUT there's a lot of truth in the saying, "A successful business is 1% inspiration, and 99% perspiration."

##### ***Business Plan Preparation***

The development of an initial business plan is a surprisingly difficult and time-consuming effort. To pull together and organize all the thoughts of the founding team, filling in the blanks, identifying and reconciling the differences, and producing a document that captures the essence of the business and helps persuade banks, investors, board members, and others to support the company is a mammoth undertaking, as anyone who has done it will attest.

Again, the plan is a necessary element of starting the business, BUT execution against the plan is where the real value lies.

##### ***Domain Expertise***

To what degree do you and your partners have meaningful experience in the business of your business? Knowing the industry, having relevant experience, and having a Rolodex full of accessible contacts can greatly improve the company's probability of success and speed its growth rate. Otherwise, it will take longer to get commercial traction and you'll have to pay for these assets, usually by hiring someone and including equity in their compensation package.

##### ***Commitment and Risk***

You've probably heard the old saying that "a chicken is involved with breakfast, but a pig is committed." Similarly, the founders who join the company full time and are committed



to making it a success are much more valuable than founders who are going to sit on the sideline and be cheerleaders. In addition, the opportunity cost for those who join the company instead of pursuing a career is not trivial.

### ***Responsibilities***

Who is going to do what? Who is going to go stay up at night when you can't make tomorrow's payroll? Where does the "buck stop"?

### **Relative Importance of the Elements**

For each company, the relative importance of these elements is likely to be very different than that for another company. A company based upon new technology is highly dependent upon the "idea." On the other hand, a new restaurant is not likely to be so unique that the "idea" is a major contributor to the restaurant's ultimate success. If we were to evaluate the ideas on a scale of 0-to-10, the technology company's idea might be a 7 or 8, while the restaurant may be only 2 or 3.

Similarly, the relative importance of the business plan will vary. A company that has to raise external financing will need a plan that will assist fund raising efforts. If the founders are providing the start up capital, then the plan will be relatively less important.

	Weight
<b>Idea</b>	
<b>Business Plan</b>	
<b>Domain Expertise</b>	
<b>Commitment &amp; Risk</b>	
<b>Responsibilities</b>	

I believe the same analysis can be productively applied to the other elements. Not only can the absolute evaluations be made (0-to-10), but they can be compared to one another for make sure that their relative values are reasonable as well.

### **Relative Contributions of the Founders**

Each of the founders can be evaluated on these elements as well. Who did what to come up with the idea? Who contributed what to the business plan? Who has the industry connections? Who is joining the company? Who is accepting responsibility for raising investment capital? Who is responsible for bringing the product to market?

	Founder 1	Founder 2	Founder 3	Founder 4
<b>Idea</b>				
<b>Business Plan</b>				
<b>Domain Expertise</b>				
<b>Commitment &amp; Risk</b>				
<b>Responsibilities</b>				

### ***An Example***



Let's look at a hypothetical example. Assume that we have a high technology start up spinning out of a university with four members of the founding team.

1. The inventor who is recognized as the technology leader in his domain.
2. The "business guy" who is bringing business and industry knowledge to the company.
3. The technologist who has been the inventor's "right hand man."
4. The research team member who happened to be at the right place at the right time, but hasn't and won't contribute much to the technology or the company.

If these were all first-time entrepreneurs, it's likely that they would each get 25% of the company's stock, because "it's fair."

Let's take a look at what the Founders' Pie Calculator says. First we evaluate each of the factors on their relative importance and each of the founding team members contribution to each on a scale of 0-to-10.

	Weight	Founder 1	Founder 2	Founder 3	Founder 4
<b>Idea</b>	7	10	3	3	0
<b>Business Plan</b>	2	3	8	1	0
<b>Domain Expertise</b>	5	6	4	6	4
<b>Commitment &amp; Risk</b>	7	0	7	0	0
<b>Responsibilities</b>	6	0	6	0	0

Next, we multiply each of the founder's values by the factor's value to calculate weighted scores. Add up the numbers for each founder, sum those totals and determine the relative percentages. Do a sanity check to see if those numbers seem to make sense, and adjust them accordingly.

		Founder 1	Founder 2	Founder 3	Founder 4	
Idea		70	21	21	0	
Business Plan		6	16	2	0	
Domain Expertise		30	20	30	20	
Commitment & Risk		0	49	0	0	
Responsibilities		0	36	0	0	
Total Points		106	142	53	20	321
% of Total		33.0%	44.2%	16.5%	6.2%	100.0%

### Advice to entrepreneurs

- Splitting up the founders' pie is not a trivial undertaking.
- Rarely should it be split evenly, even though that's what many start-ups do.
- Consider the past, current, and future relative contributions of the founding team members to the ultimate success of the company.
- Employ the Founders' Pie Calculator to create a quantified scenario of how the pie might be divided based upon these elements.



- Caution: while I have convinced myself that this is brilliant tool, and that the scenarios that I've run through it have had logical outcomes, use this tool for guidance only. Do not depend upon it exclusively.



## Chapter 36

# The Nine Drafts of the Business Plan: When is a business plan THE BUSINESS PLAN?

*By Frank Demmler*

One thing that all aspiring entrepreneurs are told is that they have to prepare a business plan. In many cases, you will look for something that will guide you through the process. Books, software packages, online guides, tapes and DVDs, sample plans, and/or seminars are just some of the many sources you might turn to for such direction. Most of these are very good at explaining the “what” of a business plan – what it should contain; what should go where; what should financial statements look like; on and on. Many of them attempt to explain some of the subtlety of the art of the plan. In most of those cases, in my humble opinion, first-time entrepreneurs don’t have the context and sophistication to appreciate what the authors are trying to say. I am going to attempt to give you a different way of looking at your business planning efforts so that you can assess where you are compared to where you need to be.

### **The Role of The Business Plan**

The business plan has two primary purposes – to help you determine what kind of business you want to build and how to go about it; and to attract the necessary resources (people, equipment, contacts, mentors, as well as money).

That order is important, by the way. First and foremost, you must plan for the business that YOU want to create. You should not create a plan primarily for the purpose of raising money, which is often the primary business planning motivation of many first-time entrepreneurs, current readership excepted.

OK, let’s get on with it. It is my opinion that business plans need to go through nine major drafts before they can be considered a real BUSINESS PLAN.

### **Draft #1: The Core Dump**

Presumably, your desire to start your business has been gestating within you for some time. During that time, you’ve thought about the business concept. You have probably clipped some articles. You may have written notes to yourself about various ideas you’ve had. You’ve talked to a number people to get their feedback.

Now it’s time to do something about it and you know that the first step is the business plan. You buy one of the guides and off you go. The first draft of your plan will be primarily organizing everything you’ve already compiled according to the structure provided by your guide.

### **Draft #2: The Best of All Possible Worlds Plan**

Your first draft will have lots of holes and inconsistencies. In the second draft, you will eliminate them so that the plan reads well and appears to be complete. In terms of effort, this draft will be the most intense. You will need to go to many sources of secondary market research to compile market statistics and do competitive analysis. You will go through the financial forecasting process in excruciating detail. The resultant numbers look reasonable and attractive, and reflect a need for an appropriate amount of capital.



This is a lot of hard work. It takes a lot of time. You will be proud of your work product. It reads well. It makes a compelling case. It contains what it should, where it should, according to your business planning guide. You will think this is The Plan. It's not.

### **Draft #3: Reality Check**

It's understandable why you would want to stop at the second draft, after all the effort you've put in. But, in your heart of hearts, you know that there were assumptions you made that were nothing more than guesses. You know where you substituted logic for knowledge. You know where you "fudged" some numbers to make the financial statements come out the way you thought they should.

If you were honest with yourself (and if you are going to be a successful entrepreneur, you must always be honest with yourself), your second draft is not what you know it could be, and should be. As much as you'd like to stop now, you know that you must press on.

The primary problem with many second draft plans is that they have not touched the real world. The real world is not always rational. The real world is a little messy. It doesn't quite perform the way you think it should. The "best" course of action is often not the course of action that will actually work. The real world is composed of people, individuals who have a tendency not to be predictable.

You need to talk to potential customers. Will the "dog eat the dog food?" Do they feel pain? Will your offering remove that pain? Is it a "gotta have"? What features do they really value? What features are they indifferent to? What features are missing? What would they pay for it? How would the customer expect it to be sold to them? By a direct field salesperson? Through existing distributors or representatives?

You need to talk to people who have "been there, done that (or better yet, doing that)."

What are the successful sales strategies that will work for a start up company? How long will it take to get regulatory approval? Do you have a "snowball's chance in Hell" of raising the money you have calculated that you will need?

The third draft of your plan will reflect the culture shock that you've experienced as person after person tells you what really happens when a company such as yours, a team such as yours, tries to create a business.

A natural initial reaction will be to defend your plan. You've worked so hard. You're drinking your own Kool-Aid so-to-speak. You want the real world to conform to your plan, not the other way around. But once the defense mechanisms recede, and you "get it," you deconstruct your plan to fill in the real world substance. This plan will no longer be complete and logically consistent. Entire sections will have been eliminated because you know now that what you wrote isn't valid.

This is an enormous hurdle, but if you get beyond it, your chances of succeeding have increased by several orders of magnitude.

### **Draft #4: Embracing the Real World**

This is a fun and liberating step in the process.

First, you now know that you don't need to act as if you know everything. It's not expected.

Second, you've learned that individuals are available to you and they will share their experiences and resources with you. They will respect you for your efforts. They will be empathetic to your needs. They only got to where they are because people helped them



and therefore, they feel the obligation to help their successors (sometimes when they're only 18, 12, or even six months removed from doing what you're doing now).

During this stage, you will get input overload. You'll find that many (all?) of the issues you are investigating don't have a single, "right" answer. The individuals with whom you talk will likely precede their comments with, "It depends, but..." They will then give you their personal opinions based upon their experiences.

You will often find conflicting advice from people in the know about certain specific topics. Is one right and all the others wrong? Absolutely not! Consider the source. Take a look at the execution. Try to understand why both may be "right" approaches for each INDIVIDUAL. How do you compare to them?

My rule of thumb:

- 30% of what an experienced person tells is very important.
- You should avoid the remaining 70% like the plague.
- Your job is to figure out which is which.

### **Draft #5: The Plan Get Soul**

This is the exciting step in the process. You've gotten good advice. You now understand what happens when the "rubber meets the road." You "get it."

Now you've got to synthesize and integrate all that you've learned into YOUR PLAN. You evaluate the conflicting advice you've received to understand the context of that advice and whether it is or is not appropriate to you and your company. You DECIDE what's right for you. You look for the inconsistencies in this emerging plan. You dig down to understand their sources, to evaluate their importance, and you resolve them. You become increasingly confident in the plan that you are developing. You engage your mentoring network in debate about critical topics. This time, though, it's not your intellect versus their experience (i.e., after the second draft), but it is between you, the wizened soon-to-be entrepreneur, versus the seasoned executive. You can hold your own in these discussions because you know in your gut that what you want to do is the right thing for you and your company. You are looking for flaws and these debates may be heated, but they are done on a peer basis.

Several critical things are going on as you prepare this draft.

Your confidence in your plan has moved from your head to your heart and gut. You are emotionally engaged in your business.

You understand the real world of launching your business and you know what you should do. You also recognize that these decisions are appropriate for this moment in time, and that as reality hits you and conditions change, you will need to adjust your plan accordingly. Blind adherence to a plan that's not working is foolish. Don't let your ego get in the way of doing what needs to be done.

Perhaps most importantly, you conduct yourself as the CEO of a start up enterprise. You have vision. You have confidence. You know that you are on the right path and people will see that in you.

This is The Plan. It is what you want to do and how you want to do it. You are confident and passionate about the business opportunity reflected in its pages.

### **Drafts #6 – 9: Packaging, Packaging, Packaging, Packaging**

Now that you know what you want to do, you need to package the plan to attract the resources that you will need. Each of these plans (#6-9) shares two common traits.



First, each “oozes” the substance of an exciting business. [I’m the only one I know who tries to explain it this way, but I haven’t found a better description or metaphor.] When someone looks at the plan, it’s obvious to the reader that this is the real deal. It’s not an intellectual exercise by a bright person who has ferreted out a market opportunity. It is the work product of a passionate entrepreneur.

Second, it is the same plan in each case, BUT what’s presented and how it’s presented is dependent upon its audience.

Banks, angels, and venture capitalists may be looking for certain financial things, so you need to present your business proposition to them in a certain way. Remember, providers of funds will provide those funds to you if you can convince them that you will return their capital to them along with a return on their investment consistent with their charter and risk profile. At the extreme, your business is nothing more than a black box to them that going to change a little bit of money into a lot of money. You are selling an investment opportunity, not your business. That’s a subtle but critical decision.

Your plan will be a recruiting tool for management team members. That packaging of the plan has to appeal to them. Can they play a significant role in the company achieving its plan? Is the potential of the plan exciting? Will it be financially rewarding? Is it worth the risk of joining during its infancy when compared to their current circumstances?

## **Summary**

Conventional business planning guides make it difficult for first-time entrepreneurs to evaluate their plans objectively. The process presented here addresses this issue more directly. Rather than focusing on the contents of the plan, it asks the entrepreneur to assess “soul” of the plan. Only the entrepreneur knows what he has put into the plan, so only he can know if it’s The Plan.

## **Advice to entrepreneurs**

- Resist the urge to stop at the second draft of your plan.
- Be honest with yourself.
- Plan the business to be what you want it to be.
- Make sure your plan reflects the real world.
- Intellectual purity, in the absence of real world confirmation, is not the foundation of a successful business.
- Package the plan, after The Plan has been developed, to appeal to the audiences to which it is directed.



## Chapter 37

### Lessons Learned: Pricing

*By Frank Demmler*

Some of the themes throughout this series of articles have been:

- Cash is king. Absence of cash is death.
- Gross margin is good. More gross margin is better.
- Gross margin is the best source of growth capital.

Perhaps not explicitly stated, but implied, the value of your company is heavily influenced by:

- The quality of your earnings.
- The rate of growth of your earnings.

All of this leads us to focus on one particular aspect of your business – pricing.

Considering how important it is, you might anticipate that I have sage advice for you.

Surely with over twenty years in this arena, and having participated in hundreds of pricing decisions, I must know the answer.

I only wish that were so. What follow are some pricing decisions that didn't quite work out as intended.

#### **Case Study #1: The Inconsequential Add-On**

An engineering software company developed and sold a package that added utility to the workstation for which it was intended. At the time, that fully loaded workstation cost about \$35,000. We priced our product at \$3,400.

The rationale for this was two fold.

First, we sold the product through value-added resellers (VARs), and we gave them a 60% margin on our product compared to the industry-standard at the time of 40%. An extra 20% of \$3,400 was thought to be a pretty enticing incentive.

Second, by pricing the product at less than 10% of the system's price, we believed that the VARs would be able to tack it on to a workstation order, with an "Oh, by the way, we suggest that you [the customer] add this product to the order. It doesn't cost much compared to the system price, and you will get more than your money's worth from its added functionality."

Compelling logic. Severely flawed in the real world.

VARs want to close deals. VARs do not want to jeopardize a deal that can close, by trying to "nibble" a few more dollars from a customer. If a VAR can close on a \$35,000 order, he will do so.

Also, VARs rarely (never?) do missionary sales. This is when something "new" is introduced to the market that requires nurturing and educating customers, with the time to close a sale measured in multiple months, if not years. At the risk of oversimplification (and the wrath of VARs everywhere), VARs like to take orders from existing customers. That immediately puts money in their pockets.

#### **Case Study #2: When Is a Sale not a Sale?**

Same company. Same conundrum. How do we motivate VARs to sell our product? Since there had been pushback on the price of \$3,400, we decided we needed to increase the financial incentives for the VAR without actually lowering our MSRP, since we had deals in the pipeline at the stated price.



The answer? A limited-time six-for-five sale. We would give the VAR six products for the price of five, effectively a 17% discount. Also, we believed that if the VARs carried an inventory of our product, they would have additional incentive to sell it. Again, compelling logic, and this time product began to move. Our sales were increasing on a month-to-month basis for four consecutive months. There were notable sighs of relief in the boardroom.

Then we started to notice an alarming trend. Our sales were growing, but our cash was declining, and upon inspection, accounts receivable (money our customers owed us) were increasing at an alarming rate.

What had happened was that the VARs saw a discount and took it, but had no intention of paying the invoices until they had sold the product to their customer (and in some cases, gotten paid by their customers). What we had counted as sales, the VARs looked at as consignments. In effect, we had created a rather expensive field-based inventory.

When this was all unraveled (and write-offs taken), less than 10% of the orders received during that time period were “real” orders. The remaining orders had been solely for the discount. While we were in the right legally, since the VARs were in clear violation of the terms of the sale, what were we to do? Sue our only customers? Not going to happen.

### **Case Study#3: Leaving Money on the Table**

As you’ve seen, it’s pretty amazing how a bunch of relatively bright people, who have quite a bit at stake, can convince themselves of their collective brilliance, and be so wrong. I could continue along this path of self-flagellation, but I think you get the point, and dredging up these memories is starting to get painful for me.

I will now share a case study with you that started the same way, but had a much better outcome.

#### ***Establishing the initial price***

In past articles I’ve talked about Automated Healthcare (now McKesson Automation), founded by Sean McDonald. The company was the pioneer in selling barcode-reading robots to hospital pharmacies. Since this was a new product in this space with few meaningful comparables from which to glean a reasonable pricing strategy, the management team had to make it up as it went along.

With that in mind, we had several objectives that at least helped us frame out thoughts. First, we would never sell a robot for less than what it cost us to make it. That meant that our alpha customers were going to have to agree to pay over \$200,000 for something they’d never seen before, and that they knew was going to be a work-in-process, but I digress.

We also knew that the tipping point at which capital spending decisions in hospitals received intense scrutiny, and thus even longer selling cycles, was \$500,000.

Further, we wanted to get \$1 million of cash flow from each robot transaction over five years, and that provided guidance for pricing our maintenance contracts.

With those boundary conditions, we priced the two alpha products at \$240,000 each. The initial beta product was priced at \$320,000 and the last one, \$430,000. The list price of the robot was established at \$472,900.

Customers were willing to pay that (often with great reluctance, but pay they did, nonetheless). Our boundary conditions were met. We were happy and confident campers.



### ***Changing the pricing strategy***

About this time, we raised a significant amount of institutional venture capital in a round led by two out-of-town investors. They were much savvier about the ways of Wall Street than we (or so they claimed and we believed, at the time). They insisted that the large dollar value of our sales would likely make our quarter-to-quarter results relatively unpredictable, and that that profile would depress the valuation that the financial markets would give us at exit.

Therefore, Automated Healthcare shifted its entire pricing strategy to doing leases exclusively. While revenue would ramp up more slowly, and profitability on a GAAP accounting basis would be pushed back, this created a recurring revenue model that would have predictability and could support higher exit valuations.

Not wanting to get too far off track, the only way this could work is if a financial company were willing to buy our leases, so that we could get cash up front, even though we were recognizing the revenue over five years. Don't let these details distract you.

We found such a finance company and we learned the art of crafting leasing deals that qualified for being purchased. How did we price the leases, you may ask? We took the \$472,500 that we were getting from the sale of a robot, applied the various leasing company discounts, etc., and reverse-engineered a lease price that would yield us \$494,000 in cash from the leasing company!

Note several things. We didn't really pay much attention to our customers in doing all of this. We used the few data points of purchases at \$472,500 to assume that an "equivalent" lease would be accepted. Second, we got more upfront cash out of the leases than we did when we sold the robots! [There were some short-term cash flow consequences of this abrupt shift in strategy, but that is another story for another time.]

### ***Setting a new sales price***

In fact the leasing program was well received and we began taking orders on that basis. What we found, though, was that some hospitals needed a purchase option so that they could prove that the lease was the way to go. We pulled out our handy-dandy calculator, took our lease and calculated a sale price that clearly made the lease the preferred option. That price was \$612,000, but we didn't really care since we weren't going to sell the robot anyway.

### ***The revelation!***

As many of you know, one of the appeals of the leasing option to a customer is that its expense can go through the normal operating budget and avoid the scrutiny of the capital spending approval process, staying below the radar screen so-to-speak. We found that some hospitals had found this practice running rampant and had prohibited leases. When we approached these clients, we explained that we only did leases. They explained that they were only allowed to make capital equipment purchases. They asked for the price of our robot, and all we had to provide was that fictitious, reverse-engineered, ridiculous selling price of \$612,000, since we "knew" that the sensible and supportable sales price was \$472,900, based upon what we had been doing only months ago.

### ***They bought the robot without batting an eye!***

Where had we gone wrong? We had accepted the conventional wisdom that we needed to keep the price under \$500,000 in order to get through the hospital's purchase approval process. We never challenged that assumption. Shame on us! We were leaving at least \$140,000 on the table!



With that insight and the superior execution of the Automated Healthcare team, the quality of our earnings made a significant contribution in justifying a \$65 million price when the company was sold to McKesson in 1996.

**Advice to entrepreneurs**

- When establishing your price, talk to customers and others in the know to find out what “the traffic will bear.”
- If you need to sell through channels (like the VARs above), my experience says that you need to focus your efforts in getting the end user to “pull” your product through the channel member. In essence, you will need to do direct selling to prime the pump. Once the VAR is having some success (albeit because of your efforts), he will be much more likely to sell your product.
- Don’t get so enamored by the brilliance of your pricing strategy that you don’t get customer confirmation before you make a company-wide commitment to it.
- Always challenge conventional wisdom, accepted industry practices, and all other assumptions. Rarely are they as firm as you might first think.
- Gross margin is good.



## Chapter 38

### Lessons Learned: Hiring

*By Frank Demmler*

“It’s management, management, management.”

That’s the phrase that many investors will cite when asked what is the most important element that they evaluate when considering an investment in a company. Variations on that theme include,

- “I bet on the jockey.”
- “I’ll take an A management team with a B idea over a B team with an A idea every time.”

If it’s so darn important, how come we continue to make so many mistakes?

#### **Nobody’s Perfect**

You are going to make hiring mistakes. It comes with the territory. Yet, rarely does a first-time entrepreneur’s plan reflect that eventuality. Most plans imply that every hire fills the necessary slot forever.

Have you included personnel turnover in your plan? Have you incorporated:

- People leaving your company?
- Having to fire people?
- The cost of severance?
- The inefficiencies of having to replace someone with a new hire who needs to be trained?
- Costs of recruiting (advertisements, headhunter fees), if any?
- The financial impact of having multiple slots unfilled at any time?

This is the reality and it will have a significant impact on your company’s operations.

First-time entrepreneurs should anticipate that at least one out of four hires will not work out and will need to be separated from the company. When one takes voluntary departures into consideration, it would not be unreasonable to assume 50% turnover in each of the first two years.

The “good” news from an investor’s perspective is that at least nine out of ten companies will be under their spending forecasts because their staffing will be behind plan.

#### **Why I’m Wary of Milestone Investing**

In the beginning of my career working with early stage businesses, I believed in milestones and tying investments to their achievement. Conventional wisdom was (is?) that milestones help to keep the management of early stage ventures focused.

That assumes that the milestones agreed to at the closing remain the company’s priorities. In my experience, though, that’s rarely the case.

Things change. Priorities shift. In some cases, strict adherence to the milestones may hurt the company. The conflict between the specifics of the milestones and the company’s needs are often difficult to resolve.

If you’re a first-time entrepreneur, all you know is that getting the next round of funding depends on hitting the milestones. The fact that things have changed is troubling, but you



can't tell your investor that you were wrong (even if the changes had absolutely nothing to do with anything you said or did). You fear that if you try to change the milestones, it will be seen as a sign of weakness. Instead of admitting and addressing the important issues, you play ostrich and forge ahead with meeting the milestones.

How does this relate to hiring?

Well, if you're like 99% of first-time entrepreneurs, you do not have a complete management team in place when you seek your initial funding. A potential investor will point that out, and after discussion with you, you'll agree that recruiting a vice president of [fill in the blank] by a specific date is a perfectly reasonable milestone. The deal is set. You close on the first tranche (a fancy word for a closing). And away you go!

As your cash dwindles and the next closing approaches, you can often find your standards for filling the agreed-to position begin to erode. After all, getting cash into the company is critical, so that takes precedence. Bad move.

I was on the board of a company that had a milestone to hire a vice president of sales by a certain date. We even had a budget to engage a recruiter to help us find the right candidate. Long story, short, we narrowed the selection to two candidates. The selection committee from the board, including the investors who had set the milestone, met with the candidates individually, and we endorsed the CEO's recommendation.

Milestone met. Next round of funding closed. All is good... NOT!

To this day, it is my opinion that this specific decision led to the company's ultimate failure (and the loss of over \$5 million of investor money).

Why?

Within 45 days, the CEO knew that the hire wasn't going to work out, but he was reluctant to bring this to his board's attention. He was afraid it would undermine his relationship with them.

I advised the CEO to work with the VP. Surely he couldn't be so bad as to not be able to do an adequate job. After all, the recruiter found him and confirmed his past accomplishments. I had interviewed him, and while he had some experience gaps that I knew were potential liabilities, they didn't appear to be insurmountable.

Remember my comment earlier about playing ostrich? Well, that's what I was guilty of. The VP's inadequacies were not obvious to the board until about the fourth month.

Finally, he was let go before the end of six months.

So what's the big deal? Hiring and firing is an everyday occurrence. I've even said as much earlier in this article.

Well, the big deal is that we had to unwind the sales organization that the VP had put into place. That took about three months.

So it took us nine months to hire, fire, and return to the status quo of where we had been before we hired the wrong VP. That's nine months of burning cash. That's nine months of market evolution without us being a meaningful participant. That's nine months of telling customers one thing and then having to retract those statements. We went from a leadership position, to one of a follower. We never caught up. The company failed.

I believe that the hiring milestone led to us hiring the wrong person. Since then, while I have reluctantly participated in some milestone-based deals, I have never allowed filling a particular position to be one of the milestones.



## **The Groucho Marx Syndrome**

Groucho Marx is remembered for many witty sayings. [I'm probably dating myself with this reference, but I hope not. Groucho should not be forgotten.] With respect to the topic of this article, I'm referring to: "I'd never belong to a club that would have me as a member."

The individuals that you want to join your company have no interest in joining your company. The first-class individuals that you should be seeking are already in good jobs. They are being recruited for senior positions with companies that are much more established (read, "less risky") than yours. There's no way that they'd ever consider your company, is there?

Yes there is. You are launching a "kick-ass" company, aren't you? [If not, why are you reading this article?] You will embrace capable professionals who will join your team and help to shape the company's future. Being part of your company will be exhilarating, challenging, and fun. Your recruit's current position can't come close to the kind of satisfaction that can be achieved in your company. That's why the recruit will join your company. You just have to convince him that that's the case!

By the way, the inverse of Groucho's Syndrome, while not absolute, is worthy of consideration. "Anybody who wants to join your company may not be someone you want to join your company." Think about it.

## **Advice to entrepreneurs**

- You are going to make hiring mistakes. Admit it when you do, correct the error, and get on with it.
- Never set a deadline, or accept a milestone, for hiring someone.
- Only hire the best.



## Chapter 39

### Revenue Participation Certificate – Keeping your Equity

*By Frank Demmler*

Many first-time entrepreneurs, when discussing their fund raising needs, often close with, “... and I don’t want to sell any equity.”

Tilt? Not really.

The vast majority of start-ups will not go public, nor get acquired. Yet, those who invest in such companies do want to get a return on their investment. Being the shareholder of a closely held corporation may not be the right structure for such investors.

It is possible to satisfy the entrepreneur’s desire for retaining his equity and the investor’s desire for a return on his investment. One such structure is the Revenue Participation Certificate.

While conceptually this appears to be fairly simple, and it is, its tax treatment can be complex. Do not try this at home. Make sure professionals assist in structuring this type of deal.

#### Deal Mechanics

As the name implies, the Revenue Participation Certificate gives the investor rights to the revenues of the company. It is structured as a “royalty,” but since that may have specific legal standing, we won’t call it that.

Its essence says:

**I will pay you X% of revenues until you get Y times your money back.**

X and Y will be negotiated in the context of your business plan. X will be large enough to provide a reasonable cash flow to the investor and Y will be set based upon perceived risk. With those numbers, you will be able to do the calculations and tell the investor that based upon your plan; this deal will provide him with a particular rate of return.

#### Benefits

First and foremost, you can avoid selling equity in your company.

Second, the deal structure, in concept, is easy to explain to potential investors and seems to be inherently “fair” to both parties.

In your discussions with the investor, the focus of the negotiation is on **when** he will get his return on investment, **not if** he will.

If the company takes longer to grow sales than the plan anticipates, the rate of return will be reduced, but it is still likely to be attractive. For example, if it takes five years to provide the return rather than the three years that was anticipated when the deal was struck, that may mean the annual rate of return might be reduced from 30% to 17%.

This structure also has the benefit of not having to establish a value for the company at the time of the investment. Since valuation is often a stumbling block for getting entrepreneurs and investors together, this structure avoids it.

It’s pretty straightforward in terms of administrative overhead, too (other than the accounting and tax issues for you, your company, and your investor).

If you are a start up, you are not obligated to start paying the investor until you have actual revenues.



The terms of the deal have flexibility and can be modified in the case of special needs or circumstances.

For example, you and the investor can agree to delay the commencement of payments until 6 or 12 months after closing so that you have some runway to put the investment to work before impacting your company's cash flow.

It avoids a common trap that first-time entrepreneurs and unsophisticated investors often get caught in – some form of profit sharing. It may appear obvious, at first glance, that sharing the profits is the way to accommodate both sides. In my experience, this is rarely the case.

Profit is what's left after your expenses. But what are your expenses, and what should they be? If you want to hire someone, your expenses will go up. Your profitability will go down. The investor will get less money. The investor may try to stop you from hiring the person in the first place.

The same circular argument can be made for all expenditures.

That's not a good situation for either of you.

An interesting phenomenon of human nature will work to the investor's benefit. The persistence of the payment (be it monthly or quarterly) will be an incentive for you to pay the security off as quickly as possible. With each successive payment, you will think of how you could use the money to grow your business, or to increase your income.

## **Cautions**

Early stage companies are inherently risky, so the reality is that the investor could lose all of his investment if your company fails. You should not be surprised if the investor wants some form of security for his investment to reflect this reality.

This may not be a wise structure for a start up. Until revenues exist and there's some confidence in their predictability, both sides may be deluding themselves.

The way a company generates revenues may change. For example, a software company may shift its pricing strategy from a license (one-time, large revenue) to a subscription (recurring lower revenues).

## **Advice to entrepreneurs**

- Deal structures are only limited by the imaginations of the involved parties.
- It is possible to structure deals without giving up equity.
- Use good professionals to make sure your deal is structured properly.



## Chapter 40

### Loan, Purchase Option and Purchase Option Buyback – Keeping your Equity: Deal Structure: Purchase Option Buyback

*By Frank Demmler*

Raising money without giving up equity is a popular topic. The previous column started: Many first-time entrepreneurs, when discussing their fund raising needs, often close with, “... and I don’t want to sell any equity.”

Tilt? Not really.

The vast majority of start-ups will not go public, nor get acquired. Yet, those who invest in such companies do want to get a return on their investment. Being the shareholder of a closely held corporation may not be the right structure for such investors.

It is possible to satisfy the entrepreneur’s desire for retaining his equity and the investor’s desire for a return on his investment...

This week’s deal structure is a Loan with a Purchase Option and a Purchase Option Buyback. That’s three separate agreements that work in concert to “do a deal.”

- **Loan** – The capital that the investor makes available to your company.
- **Purchase Option** – The investor’s right to buy 51% of your company at some time in the future.
- **Purchase Option Buyback** – Your right to buy that Purchase Option from the investor before the investor can exercise it.

Unlike the Revenue Participation Certificate that seemed to be pretty simple, this deal structure appears to be complex. I hope that I will explain it coherently in what follows. Also, while this structure has been used for financing start-ups, it is probably better employed for growth capital. By the end of this article, I hope you will understand why.

#### **Deal Mechanics**

Let’s say you wanted to secure \$500,000 for your company, but like last week’s entrepreneur, you don’t want to give up any equity. Let’s also say that I’m willing to provide that funding using this week’s structure. Here’s how that would work:

I will lend your company \$500,000 (the Loan) with simple annual interest of 10% payable quarterly (guaranteed by the company and you, personally).

The note matures on its fifth anniversary, meaning that you’ve got to pay me off at that time, although I’m willing to work with you to do that if certain conditions are met (described later).

We’re not done yet.

In addition to the note, I get an option to buy 51% of your company for \$500,000 that I can exercise on the fifth anniversary of the note (the Purchase Option).

At the same time, you get an option to buy my Purchase Option for \$500,000. This right expires in the fifth anniversary of the note (the Purchase Option Buyback).

If you can satisfy me that you can honor a new note at that time, I’m willing finance your obligations to me. In other words, I will lend you \$1,000,000 (retirement of the original



note (\$500,000) plus purchase of my Purchase Option (\$500,000)). This will be a five-year term note at 10%, just like a car payment.

	Investment	Promissory Note	Annual Interest	Purchase Option	Term Note Balance	Net Cash Flow
Start	\$ (500,000)	\$ 500,000		X		\$ (500,000)
Year 1		\$ 500,000	\$ 50,000	X		\$ 50,000
Year 2		\$ 500,000	\$ 50,000	X		\$ 50,000
Year 3		\$ 500,000	\$ 50,000	X		\$ 50,000
Year 4		\$ 500,000	\$ 50,000	X		\$ 50,000
Year 5		\$ 500,000	\$ 50,000	X	\$ 1,000,000	\$ 50,000
Year 6					\$ 836,203	\$ 263,797
Year 7					\$ 656,025	\$ 263,797
Year 8					\$ 457,830	\$ 263,797
Year 9					\$ 239,816	\$ 263,797
Year 10					\$ 0	\$ 263,797
Total Payments Received						<u>\$ 1,568,987</u>
Internal Rate of Return						18.63%

As compared to other deal structures that I've discussed, an annualized rate of return of less than 19% may appear to be a bargain to you, but it isn't really. First, your management options will be constrained by this deal. Also, it's really two deals. The annualized return on the original \$500,000 is over 22%. Then the loan of \$1,000,000 is done at 10%, yielding a blended rate of 18.63%.

### Considerations

This is a classic "carrot and stick" deal. You get money at a time when you need it without giving up any equity. BUT, if you aren't able to exercise your option to buyback my Purchase Option, I can take the note that you owe me and use it to buy 51% of your company as of the note's fifth anniversary. The presumption is that the "stick" will provide you with the necessary motivation that you will do everything in your power to avoid that outcome.

#### *The Entrepreneur's Perspective*

First and foremost, you can avoid selling equity in your company.

This structure also has the benefit of not having to establish a value for the company.

Since valuation is often a stumbling block for getting entrepreneurs and investors together, avoiding that impasse is a very real benefit. (Even the Purchase Option is defined in dollars. If it's exercised, the valuation at that time is already defined.)

It's pretty straightforward in terms of administrative overhead.

A very important consideration for you is that the nature of this deal will force you to aggressively manage for cash flow. Unlike equity deals that are targeted at capital gains, this deal is exclusively cash-on-cash.

Another reality is that you'd better make sure that this money is all that you need because this deal structure will make raising money from other sources virtually impossible.

#### *The Investor's Perspective*

First, I've got a deal that will triple my money, and then some.

Trying to fit a square peg into a round hole is never wise. I must exercise great discipline in the selection of companies that will qualify for this form of investment.

In terms of protection, if the company can't satisfy the terms of the deal on the fifth anniversary, I can convert my note into 51% of the company and take control. Then I can try to salvage whatever value I can for my investment.



Concurrently, I am betting on the belief that the prospect of this outcome will drive you to avoid it.

It is also true that if the initial investment doesn't get the company to cash-positive operations, I am probably the only realistic source of additional financing.

### **Cautions**

As I said in the opening, this may not be the right deal structure for a start up. Without existing revenues to use as the basis of a forecast, it is difficult for either potential participant to have sufficient confidence in the company's ability to satisfy this deal structure.

All parties must consider tax consequences. As tax laws change, the relative attractiveness of this structure may increase or decline.

### **Advice to entrepreneurs**

- Deal structures are only limited by the imaginations of the involved parties.
- It is possible to structure deals without giving up equity.
- Use good professionals to make sure your deal is structured properly.



## Chapter 41

### Special Situation: Purchase Order Loan – Keeping your Equity

*By Frank Demmler*

Raising money without giving up equity remains a popular topic.

This week we'll look at a special situation and a possible response: the Purchase Order Loan.

When I was with The Enterprise Corporation of Pittsburgh, one of the more frustrating situations occurred when an entrepreneur with whom we were working finally got an order, but didn't have the working capital to deliver on it.

It always takes longer to get a customer to issue an order than an optimistic first-time entrepreneur ever believes. With some regularity, we would see someone burn through all of the resources at his disposal, always believing that the order would be coming "tomorrow," and then when it did actually come, they didn't have the resources to build the product.

There is receivables' financing once the product is delivered and invoiced. Some organizations will buy invoices at a discount. How does one do "pre-receivables" financing? How can someone finance a bona fide order?

We "invented" the Purchase Order Loan to address this issue. ["We" includes Tom Canfield, John Freyhof and me.] [I use the term "invented" advisedly because I'm sure there must be others who have put such deals together, although I wasn't, and still am not, aware of them.]

#### **Deal Mechanics**

The purpose of this deal structure is to enable the company to build the product, but nothing else. It doesn't pay for overhead or salaries. It pays for the directly attributable cost of sales.

The entrepreneur still has to act entrepreneurially. He must continue to survive on macaroni and cheese, BUT, if there's an order, and if it's priced correctly, then upon completion of the order, the gross margin that the sale generates is available to fund subsequent orders and partially address the ongoing operating needs of the company. [You do remember my admonition from weeks ago that gross margin is good, and more gross margin is better, don't you?]

The basic requirements of a Purchase Order Loan are:

- A signed purchase order that can be verified.
- An acceptable and reasonable forecast of the costs associated with building the product and delivering it to the customer.
- A negotiated interest rate or other return mechanism for the investor.
- An agreement that says the loan is payable upon receipt of the customer's check, and that the loan is the first thing paid from that check.
- Personal and company guarantees.
- A loan agreement that encompasses the preceding.



Depending upon the size of the transaction, the number of parties involved, and the trust among them, this deal can be pretty simple to put into place. Also, it can be repeated for the same participants in the future with little or no cost. Just take the prior note, change the date and fill in the blanks for the new deal's specifics.

### ***An Example***

We were pretty proud of this structure and we used it with a reasonable degree of frequency under the proper circumstances. Let me tell you about a classic case.

We were working with some people who had been laid off from the Volkswagen plant that used to be in Westmoreland County. They had developed a business plan for building "kit" cars. These are body shells of classic cars from the past that replace the existing body of current (or at least recent) cars. Instead of finding a used car that the shell would fit, the guys were going to use all new parts and build a "new" car. I think the first model was a 1953 MG convertible.

[What follows may not be exactly accurate due to failing memory and poetic license, but it's pretty close.]

The idea was intriguing and we challenged them and their business plan until we were all satisfied that it was doable. The only trouble was, we couldn't raise the financing. Each car cost about \$35,000 to make and it was sold for \$60,000. Even though these were "new" cars, no bank would finance them since no secondary market existed for kit cars that could be used to comfortably calculate the collateral value of a car. We couldn't figure out a way to finance an inventory on terms that were acceptable to the founders. Eureka! Enter the Purchase Order Loan!

Each car was a separate loan agreement. Once a customer signed a purchase order for his car, a group of private investors would lend the company \$35,000 to build it. In this case, instead of an interest rate, the company and the investors split the gross margin of the transaction (\$60K - \$35K = \$25K). In this example the investor would get \$12,500 for lending \$35,000. Since the turnaround from order to delivery ranged from 90 – 150 days, the annualized rate of return wasn't too shabby. In addition, each transaction was secured by the car itself, so if the customer didn't pay for some reason, and the owners couldn't find a way to satisfy the outstanding note, the investors got the car!

This sequence was repeated successfully eleven times!

The company ultimately failed, but not for any reasons associated with this form of financing. The note holders of the twelfth deal did not get all of their money back (nor did they get a car). That's why the rate of return that private investors seek is significant.

### **Considerations**

For the right set of circumstances this deal structure can be attractive to both the investors and the founders of the company.

#### ***The Entrepreneur's Perspective***

First and foremost, you can get access to cash at a time when you most need it.

Second, once the initial transaction is structured, doing subsequent deals is relatively easy.

Third, you can avoid selling equity in your company.

It's pretty straightforward in terms of administrative overhead.

It is pretty expensive money, cash-on-cash, so you'll want to try to qualify for conventional debt as soon as you can.



### *The Investor's Perspective*

First, it's a deal with an attractive annualized rate of return.

If structured properly, it is less risky than alternative deal structures since it is tied to a specific transaction, and has explicit guarantees.

It might enable you to make significant cumulative investments in a company without having to expose a significant amount of capital to risk at any one time.

There is still significant risk involved. If your specific deal fails, do you really want to take delivery on a car, or a roll of steel, or 200 2X4's, or...

### **A Side Note**

Tom, John and I became so enamored of this deal structure that we pitched it to local economic development agencies. We weren't suggesting that they get into the kit car business, but we did try to convince them that establishing this program would be extremely helpful to some of their citizens at critical times. Also, we suggested to each that this might prove to be a competitive strength, since most economic development organizations (other than theirs) wouldn't be so progressive and able to bend their rules for something so unconventional.

Well, we were right on the last point. While several agencies were intrigued by our proposal, each time we got some enthusiasm for the program, it seemed to stall in the bureaucratic processes, never to be seen again.

Except for one organization: the [Corporation for Owner-Operator Projects](#) in Beaver County. [Mike Devich](#), co-founder and Executive Director, was sufficiently intrigued by the program that he took it to his board for consideration. The board, likewise was intrigued, and set up a meeting with me. I did the pitch. Mike and I pushed on how the potential benefits far outweighed the down side. Amazingly enough, the board approved it!

Mike was able to secure \$350,000 from foundations to launch the program. **He recently wrote me that they have done almost \$3 million of Purchase Order Loans, have had only a few write offs, and still have the bulk of the original grant available to recycle through future loans!**

While I take some pride in being part of the team that "invented" the program concept, like all entrepreneurial efforts, it's really the execution that matters. I take my hat off to Mike, his team, and his board, for having the guts and vision to do something different, and to do it superbly!

### **Advice to entrepreneurs**

- Deal structures are only limited by the imaginations of the involved parties.
- It is possible to structure deals without giving up equity.
- Use good professionals to make sure your deal is structured properly.



## Chapter 42

### Put and Call – Keeping your Equity: Focus on Returns

*By Frank Demmler*

I am now going to get caught up with a few odds and ends.

First, I will revisit another deal structure that avoids giving up equity.

Second, I want to provide an interim summary of the recent topics addressed in this series of articles.

Third, I want to give you some confirmation that at least in terms of topics, I haven't taken you too far off the beaten path.

#### **The Put & Call**

I introduced this back in the [14<sup>th</sup> entry](#) of this series, but it is worth repeating in this non-equity sequence.

“Another fairly simple structure is for you to sell a security to an investor that has a straightforward put and call. A put is an investor's right to force the company to buy his security upon specified terms - to put the security to the company. A call is the company's right to buy back the investor's security on specified terms, to call the security. A deal using this structure might be phrased:

**The company has a call on the investor's security at X times the investor's investment amount until the third anniversary of the investment. After the third anniversary of the investment the investor may put his security to the company at X+1 times the invested amount.**

Those multiples might be 2 and 3, for example, or 3 and 4, for that matter. The important point here is that you have a finite period of time to pay off your investor before the cost of that money increases significantly. Therefore you will manage your business with that in mind so that you can avoid that. By setting up these rules at the beginning, everyone knows the consequences of their actions.”

#### **Interim Summary: Nature of Returns**

As I reviewed the recent set of articles, I realized that I could put the issue of fund raising in another 2-pronged context. It seems that that's the way my mind works; everything fall into one of two buckets, regardless of the topic under consideration.

I've claimed that investment is a function of risk vs. reward. Further, I suggested that risk is composed of business risk and people risk. Taking it to the next level, I've posited that each of those risk dimensions could be divided based upon the whether a potential investor knew you, or didn't know you; and whether he knows the business or not.

Carrying that thought process further, the rewards sought by investors can be divided into two categories:

- Cash-on-cash
- Capital gains

While not particularly profound, it does give you another dimension to consider as you are plotting your fund raising strategy.



***Cash-on-cash***

These are the types of deals that we've been discussing in recent weeks. They're characterized by a specific method by which the investor will receive his return on investment. In most cases, these deals avoid giving up any equity, UNLESS the original intentions of the deal are not met and the investor has some default equity conversion rights. Such rights serve two purposes (here we go again with the "two's"). First, it is part of the incentive that you have to meet the terms of the deal. Second, it provides the investor with some protection.

Among the deal structures that fall into this category are:

- Revenue Participation Certificate
- Loan with Purchase Option and Purchase Option Buyback
- Purchase Order Loan
- Put & Call

In most cases, these deals are most likely to be employed by private investors.

***Capital gains***

Capital gains are achieved by buying a security in a company with the expectation that the company will be sold or go public some time in the future at a value that is significantly greater than that at the time of investment.

In contrast to the cash-on-cash deals that are capped on the upside, i.e., the cash to be received is pre-defined, or the formula to calculate it is defined, capital gains deals are looking for the proverbial home run.

Among the deal structures that fall into this category are:

- Convertible Note
- Convertible Preferred Stock
- Common Stock

These deals are often characterized as "high risk, high reward."

**The Wall Street Journal: Small Business, November 29, 2004**

The Journal had a special section entitled, "[The Great Money Hunt.](#)" I was pleased to see that the articles focused on topics that we've addressed in these articles.

["It's All Relative"](#) – Loans from family members.

["Long Shot"](#) – Bank loans are desirable, but hard for early stage businesses to get.

["Charge It!"](#) – Credit cards are used for small business financing more often than any other source.

["Fed Funds"](#) – Small Business Administration's main financing options.

["A Helping Hand"](#) – Economic development programs to assist start-ups.

["A Piece of the Action"](#) – Selling equity to private investors.

["Small Purchases"](#) – Valuation is only one of several important issues that an investment firm will consider before investing in a company.

["First Things First"](#) – The importance of a business plan.

[The links may require a subscription to the Wall Street Journal.]



## Chapter 43

# Entrepreneurial Leadership: Embrace Mistakes – Yours & Those of Your Team

*By Frank Demmler*

I don't know if it's the amazing success of Pittsburgh Steeler rookie quarterback, Ben Roethlisberger, but I've been involved in an inordinate number of conversations about leadership recently.

That has got me thinking about the various aspects of leadership. Among the most important traits, a leader must create a culture that embraces mistakes.

First, you must acknowledge your own mistakes and correct them.

In addition, you must encourage everyone in your company to make decisions appropriate to their responsibilities. When some of those decisions don't work out, celebrate the noble attempt, and never, ever chastise or punish someone for an honest effort.

Without glorious failures along the way, grand victories are rarely achieved.

### **Mistakes Are Inevitable**

First-time entrepreneurs often believe that there is one right answer for every challenge that is thrown their way. One right answer almost never exists. There are usually several (many?) good answers. The key is in the formulation of the planned response and execution.

As Sean McDonald, CEO of Precision Therapeutics, recently told a group of aspiring entrepreneurs, "Be satisfied with excellence. Leave perfection up to God."

### **Execute as if you know you're right, but recognize that you may be wrong**

Contrary to what you may think, the acceptance of the possibility that you could be wrong is extremely liberating. Knowing that you don't have to be absolutely right all of the time gives you the freedom to try what you think is best at a particular moment in time. [You do need to be right some of the time, by the way. I'm not advocating complete failure here.]

### **Do you want to be right, or do you want to create a successful company?**

I'll admit that I'm paraphrasing that wise man, Dr. Phil, so I apologize in advance.

Building a successful company is like fighting a war. You've got to keep the ultimate goal in mind. Winning a battle, but losing the war is not what it's all about.

Defending yourself and your decision is a waste of time and energy. Learn from your mistakes, and move on. Accept constructive criticism from one and all and thank them. Similarly, offer advice to those who have stumbled along the way.

### **Don't "Bet the Company"**

There are mistakes and there are MISTAKES.

Before making any decision, assess the possible damage if the decision is wrong. In all but the most extreme cases, don't bet the company on a single decision.



- Maybe it's not the right time to spend all of your remaining cash on a four-color, inside-front-cover advertisement in an industry magazine.
- Maybe you shouldn't outsource the production of your product right now.
- Maybe you shouldn't open up five regional sales offices.

### **Mistakes of Commission Are Better Than Mistakes of Omission**

An underlying theme throughout these comments is a bias toward action. If you make a decision and implement it, presumably you're doing so with some anticipated outcome in mind. [You'd better be.] If that outcome doesn't occur, you can try to evaluate why and do better the next time.

Conversely, if you don't do anything and you have a bad outcome, what do you fix?

### **Decisions Must be Made with Incomplete Information**

If you are a first-time technology-oriented entrepreneur, you are likely to want as much information as possible when faced with important decisions. But complete information is an ideal that can never be achieved.

In fact, delaying a decision in the anticipation of getting more information is often more damaging than making an immediate decision and adjusting to the outcomes as needed.

R.F. Culbertson, CEO of Eidoserve, recounted a meeting he (and many others) had with Colin Powell, when he was the Chairman of the Joint Chiefs of Staff. R.F. was surprised when Col. Powell said that he expected his commanders in the field to make their decisions when they had roughly 40% of the potentially available information.

If they are expected to make potentially life-and-death decisions with only 40% of the information, how much do you really need?

### **Practice, Practice, Practice**

Creating this kind of culture is not very easy. The behavior is one that often has to be learned. Therefore, I say to you, PRACTICE MAKING MISTAKES!

Now I don't mean that literally. What I do mean is that you, first, and members of your team, second, should consciously make decisions more quickly than you have in the past. Monitor how they work out. Learn from them.

Also, learn about yourself. Where are your comfort zones? Why? What are the defense mechanisms that you use to avoid making decisions? If you recognize them, you can combat them.

Pull your team together and discuss the challenges facing the company. Pick one of them that has been delayed pending receipt of additional information. Ask, "If we had to decide today, what would we do?" Once that response has been solicited, implement it immediately!

If you are going to be successful, you need to develop your panic armor. You need to exercise your gut decision muscles. You need to experience the relief that the sun really does rise the next day after you've made a monumental blunder. You need to view mistakes as learning experiences. You can only be sure if you've been there and done that. Develop the mindset. Develop the experience.

You need to nurture the same skills within everyone in your organization.

Just like Ben Roethlisberger, when your team is down by 2 points with less than two minutes left in the game, you need poise. You need faith that your teammates will



execute their jobs as they should, improvising as necessary. You need the confidence that as the rushing defenders (your competitors) try to take you out, that you will make a good decision when it matters, and you and your team's execution will yield victory. [I apologize if this metaphor is annoying, but I'm writing this just after the Steelers' victory over the Jets, so I'm a little giddy with football at the moment.]

### **Concluding Advice**

The following pieces of advice concern your relationship with the members of your team. They may appear to be trite, but they contain a lot of truth, so consider them carefully.

- Praise in public. Counsel in private.
- Pass on credit. Take blame.
- People don't have to like you, but they do have to respect you.



## Chapter 44

### Cookie Cutter Businesses: Building your business one cookie at a time

*By Frank Demmler*

Many businesses are self-contained economic units. Restaurants, retail outlets, day care centers, bowling alleys and movie theaters are some obvious examples. Each unit has a limit to its growth – physical capacity, production capacity, geography, hours in a day, legal limits on hours of operation, etc.

Growth of these businesses is accomplished through opening new units. These are often called “cookie cutter” businesses; the proven formula is repeated time after time. Among the approaches to growth are:

- organic growth – one unit at a time as resources permit,
- chain of company-owned units – preplanned opening of multiple units, and
- franchising – preplanned system that enables others to own and operate units.

Each path is materially different from the others, and should be carefully chosen.

More on that later.

#### **Template for Growth**

Regardless of the growth strategy, in my opinion, the initial steps can be very similar:

- Open an initial unit;
- Open subsequent units to refine the formula; and
- Open units beyond that to prove that you can clone yourself.

#### ***Initial unit***

Develop a plan, get constructive criticism by those knowledgeable in the business, and launch the first unit. One of the primary purposes for this first unit is to find out what’s right and wrong with your plan.

If you’ve already had profit and loss responsibility for a unit of an existing chain (which I highly recommend), you are still likely to experience some surprises with the start up process, and you will definitely be challenged by cash flow management.

If you have never run a business like the one you are starting (as is often the case with restaurants and retail outlets), you will be on a steep learning curve. You are likely to be amazed by the differences between reality and your plan.

#### ***Concept refinement***

Now that the real world has infiltrated your dream, you need to make the necessary adjustments and confirm their effectiveness. Depending upon many factors, it is possible (although unlikely) that a second unit is all that will be necessary.

The primary purpose of this step is to determine the “cookie’s recipe,” so to speak. What needs to be done so that a single unit will financially and operationally attractive.

#### ***Proof of Concept***

This is the critical step in the process. Your personal involvement in the prior steps will be a significant factor in their success. In order to grow, you will need to package the process and confirm that someone can be taught to do what you’ve done.



Among other things, during this step you will develop a training program and an operations manual. The manual will be a “cookbook” for starting and running a single unit. This is not a trivial task. It needs to go into excruciating detail so that a unit manager can refer to it whenever she has a question.

***Other infrastructure activities***

In order to grow, you will need to put certain resources in place. Someone with experience will have to prepare the aforementioned operations manual and training program. These might be consultants, or people you hire. Someone has to do the training. Systems infrastructure will have to be selected and installed. The overall complexity of everything will stress your ability to manage it.

One of the critical skills that you will have to develop is that of site selection. “Location, location, location” will be a critical factor in the success of your operating units. You may be able to base your first few locations based upon your “gut,” but ultimately you will have to reduce it to a disciplined, data-based process.

Other activities depend on your growth strategy. Company-owned stores will require sophisticated financial management, for example. Franchising will require a franchisee solicitation marketing program, and people to implement it.

As I believe you have surmised, these steps require a great deal of effort, advanced planning, and resources (capital).



## Chapter 45

# Growth through Cutting Cookies: Make sure you Know Where You're Going – Different Growth Strategies Can Lead to Very Different Destinations

*By Frank Demmler*

In the previous article, we looked at “cookie cutter” businesses. These are businesses that are self-contained economic units. Restaurants, retail outlets, day care centers, bowling alleys and movie theaters are some obvious examples. Each unit has a limit to its growth – physical capacity, production capacity, geography, hours in a day, legal limits on hours of operation, etc.

Growth of these businesses is accomplished through opening new units. Among the approaches to growth are:

- organic growth – one unit at a time as resources permit,
- chain of company-owned units – preplanned opening of multiple units, and
- franchising – preplanned system that enables others to own and operate units.

Each path is materially different from the others, and should be carefully chosen.

### Franchising

Franchising is a business model and strategic decision, not a financing method. This distinction is often missed by the first-time entrepreneur.

The conventional wisdom goes something like this:

I'm going to start a franchise because I can grow my business with other people's money. The franchisees will be responsible funding each outlet. That let's me grow quickly and reduces my risk. On top of that, the up-front franchise fee is all profit and will help cover some to my corporate overhead. To me, that's obviously much more attractive, and more rewarding, than slowly building a chain of company-owned stores. From the outside looking in, those are reasonable observations, but they are way off the mark.

First and foremost, if you choose the franchise structure, your business is selling franchises, not running a chain of restaurants [or whatever the self-contained economic unit is]. Before a franchisee is going to fund her outlet, she has to be convinced that she wants to buy a franchise, and of all the available franchises, yours is the right one for her. You don't franchise by hanging up a shingle. You've got to develop a marketing plan that brings you to the attention of potential franchisees. You've got to manage a sales process that converts the prospective franchisee into your franchisee.

- Where should you advertise (Wall Street Journal, Entrepreneur Magazine)?
- Which trade shows and conferences should you attend? What kind of presence should you have? Do you need professional booth? How will you staff it?
- What should you include in your franchise kit? Who will design it?
- How do you close the deal?

This all takes time, money and staffing.

Oh, by the way, there's got to be some substance to you as a company, as a credible franchisor. You need operations manuals; training programs and trainers; and site



selection expertise and methodology, among other things. You need extensive legal work to properly establish your company's ability to franchise, and to make sure you comply with the laws within any geographic area in which you want to sell a franchise.

You will need to find initial franchisees who are willing to make an extraordinary leap of faith to buy a franchise from you. You will need to meter your efforts because significant growth cannot be achieved until successful franchisees can be pointed to as models for what the prospective franchisee can become. Again, these take time, money and staffing. About that franchise fee – if your franchisee solicitation program breaks even through the collection of those fees, you will be lucky.

Of course, all of this is for naught, unless your franchisees are successful over a long period of time. Again, the appearance of “free” money from franchise royalties is also a myth. A good franchisor with successful franchisees will be spending a lot of money making its franchisees more successful. Franchisees really are expecting, and demand, services for their royalties, or they won't renew their franchise agreements.

Franchising is not a panacea for growing a business rapidly. One set of challenges is being replaced by another.

### **Company-Owned Chain**

As compared to franchising, building a chain of company-owned outlets is less complex and you have greater control. The offset is that the capital requirements are much greater and growth is likely to be slower.

Regarding control, you don't really “control” a franchisee. Yes, they will sign a franchise agreement. Yes, that agreement proscribes certain ways that things will be done. BUT, there is no guarantee that the franchisee will comply to the letter of the agreement as you intended it.

Certainly you can influence compliance by inspecting the franchisee and auditing its practices, but if they aren't compliant, what can you do? You can turn your lawyers loose and maybe the conflict will be resolved in 3 years, but in the meantime, what has happened? Your other franchisees will certainly be aware of this battle between you and one of their peers. Time and money have been diverted.

Alternatively, with a company-owned facility, staffed by your employees, you can require performance of a certain type. Non-compliant employees will be terminated. Things will be done as you intend them or immediate action can be taken to rectify problems.

### **Financial Implications**

As I hope you've seen, these are two entirely different businesses, that only share external traits, but are very different in terms of their actual operation. The funding requirements are also different.

#### ***Operating Units***

Each path has to have at least one company-owned operation at the beginning. Beyond that though, the next steps are situation-specific. Some franchisors have launched franchising after a single unit is up and operating. I wouldn't recommend that, but it has been done.

For the company-owned chain to grow, investors have to be convinced that the individual economic unit generates the kind of cash flow that is appropriate to the investment and



that the units can be replicated with success. Those issues may be resolved with only two outlets, but it's likely to take more than that to remove sufficient risk that significant investment will be available on attractive returns.

The potential investor in a franchise will need to be convinced that you can predictably attract enough franchisees that the financial performance of the franchise system will yield the financial results that will lead to an attractive exit for that investor. In this case, you need to invent the cookie, implement it and then get others to buy the recipe and make their own cookie. What do you as franchisor need to do to get to that point, where growth capital is available, and available on acceptable terms?

### ***Infrastructure***

In the case of the company-owned chain, you can control the rate at which you build infrastructure, and its breadth and depth. You control rates of growth, and thereby cash requirements. The development of infrastructure will not be a primary driver in an investor's perception of your risk. The people "at corporate" will play important roles, but they will be more supportive in nature. Success or failure will be measured by the success and failure of the operating units.

In a franchising environment, it is almost 180 degrees out of sync with that. The corporate capabilities are what will determine success and failure. First, there will have to be a critical mass of people and capability so that you are viewed as a credible franchisor who can provide the necessary support and services that can attract franchisees. These capabilities must be available before you can get your first franchisee. You may be able to contract out some of these capabilities, but you'll still have to oversee the contractor's delivery of those services.

The previously mentioned marketing and sales plans for securing franchisees will need to be developed and proven to be replicable. The perceived risk of the franchise business centers on your ability to sell franchises.

### ***Observations***

Fund raising is a function of perceived risk and potential reward.

In my opinion, the initial investment in a company-owned chain will be viewed as less risky than franchising, from an investor's perspective. The path to proving the business model is more direct and under your control. In a franchise, a large portion of the initial capital will go into infrastructure, and success is less easily measured.

Offsetting this is the knowledge that the overall capital requirements of a chain of company-owned outlets will ultimately dwarf those of a franchisor; the potential reward is likely to be perceived as lower as well.

Another benefit of the company-owned facility is that you will have several funding options. In some cases it is possible to grow by funding each single outlet as a standalone enterprise. Investors can be sought for a single restaurant, for example. You might set up a limited partnership so that your company is the general partner and the investors will get some defined return on their investment. This has the benefit of isolating the amount of capital needed. It also preserves your equity in your business. By the way, this is usually a transitional strategy until the perceived risk has been adequately reduced so that significant investment into your company on reasonable terms is available.



## Organic Growth

Some people start businesses that have these characteristics as a lifestyle choice. They enjoy the business itself and they run it to achieve an acceptable level of income and a certain quality of life. Growth, or building a chain is not high on their priority list.

Still, when the first unit is a success, there's inevitably an urge to do it again, and when that's successful, do it one more time, and so on and so on. This needs to be done with forethought as well. Otherwise, you may end up in a place you never intended.

One of the reasons your first outlet is successful is because you are personally involved.

If you open up other units, your efforts will be diluted over multiple outlets, and you will have to manage the people who are doing the job you used to do. Will those people bring the same passion and involvement to the business? Probably not.

In addition, the complexity of managing the entire business will increase as the square of the number of outlets. While you may secure volume discounts from your vendors since you will be increasing your orders, the cash flow implications may be daunting. The size of your payables may rise to uncomfortable levels. Your vendor may be more aggressive in his collection procedures since you represent a larger liability to him.

If you try to run multiple businesses the same way you ran just one, it is highly likely that the wheels will come off the tracks. If you accommodate these new demands by adding people, you may be increasing expenses without a corresponding improvement in margins.

If these things were to occur, your enjoyment of your job would decline; your income may fall, not rise; and the quality of your lifestyle may deteriorate. That's not what you had in mind, is it.

## Conclusion

None of these growth strategies is right or wrong. They are just inherently different, and are likely to lead to different destinations. These alternatives should be analyzed before one is selected. Thinking ahead can make all the difference.



## Chapter 46

# Schizophrenia: Same Person, Different Roles, Different Answers

*By Frank Demmler*

They should have known better. I sent in my check for Super Bowl tickets. I wasn't selected for tickets in the lottery. You know what happened next. Talk about conflicting emotions.

I mention this because in the past week I've had discussions with several people with roles and responsibilities that were muddled, and the individuals needed some help in sorting through it all.

### Founders

Founders are in a particularly precarious position. Consider the simultaneous roles that they play:

- Private citizen
- Founder
- Shareholder
- Director
- Officer
- Executive
- Employee

In the beginning, all of these roles are closely aligned, but overtime each takes on a specific character, often in conflict with one another. The differences are often magnified when an investor is brought on board.

Consider the founder-director-shareholder. The director has a responsibility to make decisions based upon what's best for **ALL** shareholders. The shareholder is driven by self-interest.

What does he do if a company offers to acquire "his" company? It is clear that selling the company is in the best interests of **ALL** shareholders. The investor gets a chance to exit on attractive terms. The employees with options have an opportunity to realize the benefits of all their hard work.

But you, the shareholder, doesn't want to sell. Maybe you think there's an even bigger exit opportunity in the future. Maybe you don't want to work for someone else. Maybe you don't like the acquirer. Whatever the reason, you don't want to do it.

How do you resolve this conundrum? Strictly speaking, it's pretty straightforward. As a director, you have to vote, "Yes." When it is submitted to the shareholders for approval, you will vote, "No."

Is that the end of it? Not likely.

If you don't own enough shares to block the acquisition, your vote will be counted, and the acquisition will proceed. In fact, if it's inevitable, you may vote in favor of the deal just to avoid the appearance of dissension.



If you can block the acquisition, things will get very interesting. In all probability, you're likely to sell the company anyway, but not before you go over a few bumps along the way.

As a practical matter, if discussions with the acquirer were to get to this point, everyone but you will be thinking about life after the acquisition. The investors are thinking of the distributions to their investors. The employees are daydreaming about the Harley, the boat, and the college fund.

You will come to the realization that even if you could stop the transaction, it would likely be a pyrrhic victory. Your company will never be able to return to what it was. Recognizing that, you're likely to negotiate some form of consideration for voting your shares in support of the acquisition.

### **In the Beginning...**

While I'm sure you haven't committed this sin, many start-ups begin with great intentions, but naive expectations. For example, let's say that you invented something, and you and a friend started a business based upon that invention. You may not have considered some of the issues associated with the ownership of the intellectual property. For the two of you, it's not a problem, at least at the beginning. One for all, and all for one; that sort of thing.

After some time passes, your company attracts investment interest. As part of the due diligence, the ambiguity about the ownership of the intellectual property surfaces. The investors want you to assign all of your IP rights to the company. Now, what do you do? It was "understood" that you were "contributing" your IP to the company way back when, but it was never reduced to a legal agreement. Things were simple then, but they're getting complicated now. What did you really intend back then? ...that the company would have complete rights to your technology? ...that the company would have limited rights restricted to specific fields of use? Did you even think about these issues?

What are your legal obligations? ...your moral obligations? As a director, you understand why the company wants the rights. As the inventor, you want to retain the rights. As a director, you understand the value to the company of bringing the investors on board. As the inventor, you resent being pressured to give up your rights.

This is another situation where you're in the legal right, but are likely to have to give in. The reality is that investors are highly unlikely to invest without the company owning the IP, or at least having an exclusive license to it. You may be able to get consideration of some sort, but the disposition of the IP is pretty much preordained if you need growth capital from investors.

### **Talking about legal stuff and lawyers...**

When you start your business, you and your company are pretty much synonymous.

When you engage an attorney, your interests and those of the company are aligned. If you've selected the right attorney, she will become a trusted advisor. But, overtime, your interests and those of the company are likely to diverge [see above].

When a significant event occurs that requires legal input, "your" attorney is looking out for the company, not you. Let me say that again. **Your attorney is looking out for the company, not you.** In many cases, that may not be a big deal, but in others, you may be unknowingly vulnerable.



In one memorable case, a company with which I was involved had gotten its initial funding from local sources. The management, investors and board members were all well known to one another. We were all comfortable with one another and the fact that we could trust one another. We knew that one another's word was his bond. [Perhaps naïve in today's world, but that's a whole other article.]

We had received an investment offer from some out-of-town institutional investors. I talked to the founder-CEO and cautioned him that when the new investors come on board, they will not be obligated to honor any "understandings" that the CEO had with the existing board. I also pointed out that he probably should get an attorney to represent him personally, for the reasons just stated.

As I knew it would, it created a flurry of activity, some of it unpleasant, but necessary. The CEO's deal was put in place and he was legally protected as the company moved forward. At the exit, these actions had a material impact on what the founder received.

## **Conclusion**

In an entrepreneurial setting, the individuals involved often wear many hats. Quite often the different roles will have different perspectives on the same issues. Not only are you likely to find yourself in legal quandaries on occasion, but also the moral and ethical considerations will be surprisingly complex.

If you're going to be an entrepreneur, schizophrenia will be a way of life.



## Chapter 47

### Keeping Investor Syndicates in Line: Pay-to-Pay – Term Sheets have Changed in an Interesting Way

*By Frank Demmler*

Last week I provided some statistics about venture capital in 2004 as reported by the National Venture Capital Association.

VentureOne, another venture capital “scorekeeper,” also recently released an interesting study. They analyzed a sample of venture capital deals and reported the results. There were two statistics that caught my eye.

- 23% of the transactions were down rounds (with 17% being flat; 41% being up rounds; and 19% being “N/A”), and
- 47% of first rounds included pay-to-play terms.

[I know that these aren’t “apples-to-apples” numbers, but even 27% of later stage deals had pay-to-play provisions.]

Don’t worry; I’m not going to bore you with lots of numbers, like last week. I’m going to provide you with my interpretation of these two statistics, and why they are of extreme interest to you, the first-time entrepreneur.

#### Investor Protection

As I’ve discussed in previous articles, institutional investors almost always invest in Convertible Preferred Stock. In addition to a variety of “preferences” associated with the stock, there are quite a few protective provisions, i.e., protection for the investors to prevent the company from taking an action that is detrimental to the investors without the investors participating in the decision, or having the right to veto it.

The most notable is anti-dilution protection. This addresses what happens if the company has to sell stock at a price below that of the current investors. Two methods are employed.

- Full-ratchet protection gives the existing investor an adjustment so that it’s the same as if it had invested in the current round; and
- Weighted average protection takes the share base into consideration in the adjustment.

Other protections include such things as:

- Liquidation or sale of the company
- Alter any provision of the corporation would be adverse to the investors
- Create any security that is senior to the investors’ security
- Borrow money greater than some amount.

The common theme of these features is that they are expressed in terms of protections that the investors “need” from the company.

In many cases, their primary purpose is to provide protection from the next round investors. By having these types of rights, the thinking goes, the current investors will have bargaining chips to trade with the follow on investors.



The Golden Rule still prevails, though – he who has the gold rules. In other words, if there's only one investor interested in the deal, the current investors are likely to have to waive their rights.

### **Protection Extension**

What's significant about the two statistics that I cited in the introduction is that **investors and now seeking protection from one another**.

Historically, syndicating a deal (a lead investor with one or more co-investors) has been a staple of the venture capital industry, with few exceptions. Among other reasons, it has been claimed that this mitigates any single investor's risk by having a broader and deeper pool of capital at the table, so to speak.

In the case of having only one new investor that dictates terms of the next round, the current investors have the “dry powder” to fund the portfolio company themselves, thereby preserving their rights.

This was the norm for quite awhile in the venture capital industry. If faced with a down round, the options were often pretty straightforward.

- Let the company crater.
- Accept the terms of the new investor.
- Do an inside round.

Down rounds were pretty rare [I don't even remember statistics being reported on them.] If an inside round was the selected path, there was an “understanding” that the current investors would share the round on a pro rata basis.

On those rare occasions that the syndicate didn't hold together, it was “understood” that you had to “pay-to-play.” In other words, if a current investor would not, or could not, take its share of the next round, their existing investment would be essentially worthless and they would have no rights moving forward.

I remember the first time I was in this situation. The prior round had been done at \$1.00 a share, but for a number of reasons no new investor came forward. When one investor balked at putting more money into the company, the next round was priced at \$0.05 per share, a 95% write down for the current investors. This is what is known as a “cram down.”

### **Times Have Changed**

The number of down rounds is now significant (23%, according to VentureOne; even higher if you take the “N/A” responses out of the calculation).

Similarly, syndicates are not as strong as they were in the past. As such, “Pay-to-Play” terms are explicit parts of current deals. Similar to anti-dilution, there appear to be two primary mechanisms, and one appears to be harsher than the other. If an existing investor does not take its pro rata share of a down round:

- The investor will automatically lose the right to participate in future rounds, or
- All of the investor's shares will automatically convert to Common Stock.

### **Implications for Entrepreneurs**

Among the reasons that raising capital is so difficult these days is that your potential investor knows that a down round and/or a disintegrated syndicate are distinct possibilities. Even companies that “do all the right things” are exposed.



- Do everything you can to demonstrate that you will be immune to a down round.  
[Short of “proving” that you will be cash flow neutral with the existing investment, I’m not sure how you do that, but...]
- Target investors who have sufficiently deep pockets to fund follow on rounds, and a history of doing so. Such investors are few and far between.
- Target those groups of investors who have a history of investing together and have weathered difficult times together.
- When all else fails, if the cash is green and legal, take it.



## Chapter 48

# Guerrilla Marketing: Getting a Bigger Bang from your Marketing

*By Frank Demmler*

This is the first of an occasional series of articles on one of my favorite topics: Guerrilla Marketing.

To the best of my knowledge, Jay Conrad Levinson coined this phrase in the early 1980s. It refers to the need for entrepreneurs to employ imaginative tactics to get more than \$10 of value out of every \$1 that's spent. There's a series of books on the topic, of which my favorite was "The Guerrilla Marketing Handbook."

### **"As advertised in TIME Magazine..."**

Jay told the story about the owner of a new San Francisco furniture store that wanted to establish an identity and credibility by placing an advertisement in a national magazine. The cost of a full-page national four-color ad was on the order of \$60,000. That was a non-starter for this entrepreneur.

He then learned about Remnant Advertising. Most publications rarely sell all of their advertising space. In order to fill all of the space, the open slots are sold at significant discounts just before press time.

He paid \$1,395 for his advertisement in the Atlanta, GA regional edition of TIME Magazine! Yes that's right. His store was in San Francisco, CA and he ran an ad in the Atlanta, GA edition of TIME Magazine. What was he thinking?

He was thinking REPRINT. He ordered reprints of his ads with a prominent banner that said, "As advertised in TIME Magazine."

Instant credibility!

### **Gorilla Marketing**

Before he became Allegheny County Executive, Jim Roddey was a successful entrepreneur, and very generous with his time for civic activities. This story comes from that time.

I used to be involved with an annual conference that was the predecessor to The Entrepreneurial Growth Conference presented by the Duquesne University Small Business Development Center.

Knowing that Jim was a superb salesman and marketing guru, I called and asked him to speak at the conference about Guerrilla Marketing. He agreed, as he usually did.

Come the day of the conference, Jim showed up promptly for his presentation and as he approached the stage, he handed me a single slide (that will give you a sense of how long ago this was). I marched to the projector, took the carousel, remembered to put the slide into the carousel upside down and backwards, and waited for Jim's cue.

He strode to the podium, and began his presentation.

"I don't know how Frank knew that my family owned a small zoo in the South. During the Depression things got pretty bad and we had to close the zoo. We sold everything from the zoo, except for one thing... Frank, show the slide."



As the projector light came on, Jim said, “We sold everything but the gorilla. Now let me tell you about Gorilla Marketing!” and the picture of a big old gorilla came into focus on the screen.

**Turning \$3,000 into \$250,000  
(probably \$10,000 into \$1,000,000 in today’s dollars)**

After the laughter subsided Jim then launched into a series of anecdotes that were excellent examples of Guerrilla Marketing. This is my favorite.

Jim and a few of his business associates purchased a low rated radio station in a Southern community. They changed the station’s format and were confident that once people tuned in, they would stay, increasing listenership, increasing advertising rates, and make the station a commercial success.

The challenge was to get people to go to the station in the first place. The traditional way would have been to spend lots of money on billboards, concert sponsorships, remote broadcasts from the local grocery stores and auto dealerships. Jim and his friends didn’t have a lot of money, and they didn’t think the old methods would work. The South was changing and the station had to change with it.

So, this is what they did.

They sponsored a contest. The prize would be a college scholarship (which in those days cost about \$3,000 for the state college). In this town, it was the first generation that had college aspirations and parents who supported their children building a life for themselves that didn’t necessarily include staying on the family farm.

The rules of the contest were something like:

- Paint your car with the station’s call letters and frequency in as noticeable manner possible,
- Come to the station on April 1 to have a picture taken of your car,
- Leave the paint job intact while driving around the community,
- Come by the station on June 30 to have another picture of your car taken to confirm that the same design was there as April 1,
- Screen the cars for confirmation of eligibility (followed the rules), and
- A panel of design experts will select the winner.

For three months, cars were driving all through the community with the call letters and frequency of the radio station heralded by their paint jobs.

After the contest, it was calculated by the advertising and promotion metrics of the day, which it would have taken \$250,000 to create an equal number of impressions by conventional methods!



## Chapter 49

### Enlightened Serendipity: You'll Know When it's Time to Start Your Business

*By Frank Demmler*

One of things I've observed about the fraternity of those who provide entrepreneurial advice and education is that we say similar things, but we have our own way of presenting it.

- Jack Thorne characterized entrepreneurship as, "Insane perseverance in the face of total rejection."
- Jack Roseman has captured the essence of his perspective in the title of his excellent book, Outrageous Optimism.
- Fred Beste has a series of articles, including the classic, "25 Entrepreneurial Death Traps."
- Ron Morris has his "75 Immutable Truths."

To this list I humbly offer "Enlightened Serendipity."

#### Enlightened Serendipity

Being in the right place  
At the right time,  
Recognizing it, and  
**Acting** upon it,  
**APPROPRIATELY** and  
**PASSIONATELY.**

An observer can often be heard exclaiming, "What luck!" or "Another overnight success!" when reacting to someone's achievements. Nothing could be further from the truth.

True, intuition and flashes of inspiration may play a role in the process, but these seemingly sudden bursts of accomplishment may have been gestating for years, perhaps decades, with conscious preparation throughout. It is the confluence of personal and external events, trends, and developments; many controllable and some that are not, that ultimately lead to opportunity. It is the TRUE entrepreneur who has prepared himself and successfully grasps the opportunity to make it his own.

Right now and right here – is your opportunity at hand? Do you expect it to be? If not, how will you **recognize** it?

Have you ever exclaimed, "That was my idea!" when someone achieves success? At the risk of hyperbole, ideas really are a dime a dozen. Having an idea is one thing. **Acting** on it is quite another.

"If only I had the money..." "Once I close on a round of investment..." The everyday person frequently finds reasons not to do something. The entrepreneur scales his pursuit of the opportunity to a level **appropriate** to the circumstances and prospects.

"It should have worked..." "If only I'd had one more round of investment..." Virtually every successful company I know was essentially bankrupt by all rational measures, but the **passionate** founders refused to accept that outcome. When others are ready to throw in the towel, entrepreneurs redouble their efforts to make it work!



**Opportunity Obsession**

Entrepreneurs are obsessed with the pursuit of opportunities. Unlike administrators who attempt to optimize outcomes based upon a given set of resources and constraints, the entrepreneur pursues opportunities without regard to the resources currently under control, but with the confidence that they can be attracted when needed.

I am a firm believer in the adage that if you throw enough mud against the wall, some of it will stick. Through business planning activities; networking with other entrepreneurs, professionals, and business practitioners, among others; and attending conferences, trade association meetings, virtually any gathering of people; the budding entrepreneur will be exposed to an unlimited number of opportunities.

Entrepreneurs will seize opportunities while others see only noise and confusion.

**THAT** is Enlightened Serendipity.



## **Chapter 50: Dilution?: It May Not Be What You Think**

*By Frank Demmler*

Anti-dilution protection. Everyone has heard that phrase. Most people think they know what it means. Many first-time entrepreneurs don't. That can lead to huge mistakes. One of the problems is that "dilution" has several meanings when it comes to doing a deal.

### **Percentage-Based Dilution**

If you own 60% of the equity of your company before an investment and 30% afterward, that's dilution.

If an investor owns 40% of your company before a round of investment and 20% afterward, that's dilution.

BUT that's NOT the kind of dilution that anti-dilution protection applies to.

### **Share Price Dilution**

Confused?

Well, let's talk about the kind of dilution that investors do seek protection against.

If an investor buys shares of stock in your business at \$1.00 per share and the next round of investment is at \$0.50 per share, now that's dilution.

### **Getting Back to Basics**

Let's go back to some of the first things we talked about in this series of articles.

- Deals are negotiated with percentages, but are structured with shares.
- The value of a company is only known at the instant of a transaction when cash is being exchanged for equity.
- The value of a company is determined by multiplying the total number of common shares by the most recent share price.
- $\text{Pre-Financing Value} + \text{Investment} = \text{Post-Financing Value}$ .
- $\text{Pre-Financing Value} = \text{Post-Financing Value} - \text{Investment}$ .
- $\text{Price per share} = \text{Amount of investment divided by the number of shares purchased}$ .

That's all pretty dry and boring gobbledygook, unless it's your company and you're doing the deal.

### **The First Round**

Let's translate some of this into an example.

- I offer to invest \$400,000 in your company in exchange for 40% of it.
- Since you own all 600,000 shares of your company, I am offering to buy 400,000 new shares in order to acquire 40%.
- My investment of \$400,000 divided by 400,000 shares that I'm buying yields a per share price of \$1.00.



- Since you own 600,000 shares, that means the value of the stake in your company is \$600,000, which is the pre-financing value.
- Adding my \$400,000 to that yields a post-financing value of \$1,000,000.
- That is confirmed by taking the total number of outstanding shares, 1,000,000 (your 600,000 and my 400,000) and multiplying that by the share price of \$1.00.
- That also says that the post-financing value of your company is \$1,000,000.

	Investment	Price per Share	Shares	%	Post-Financing Value
You			600,000	60.0%	\$ 600,000
Investor 1	\$ 400,000	\$1.00	400,000	40.0%	\$ 400,000
Investor 2					
Subtotal			400,000	40.0%	\$ 400,000
Total			1,000,000	100.0%	\$ 1,000,000

Everything is in balance. The world is good.

### The Good Second Round: Share Price Increase

As time progresses, you and your company forge ahead. It's time to raise some more money. Fortunately for you, you are in a business that venture capital investors are interested in. Several of them are looking at you, and after a while you negotiate a deal with one of them.

- The new investor offers to invest \$2,000,000 for 50% of your company.
- If 50% of the company is worth \$2,000,000, then the total company must be worth \$4,000,000.
- Since there are 1,000,000 shares outstanding today and they will represent 50% of the company after the financing, then the new investor is buying 1,000,000 shares.
- The \$2,000,000 investment divided by 1,000,000 shares yields a share price of \$2.00.
- Since I paid \$1.00 per share, I'm happy. In fact, the 400,000 shares that I paid \$400,000 for are now worth \$800,000 (400,000 shares X \$2.00 per share).
- The value of my investment has appreciated (grown in value).
- Even though the percent of the company I own has decreased (been diluted) from 40% to 20%, I'm happy.
- By the same reasoning, your equity stake is now worth \$1.2 million, and you've got \$2,000,000 of investor's money to pursue your dream!



	Investment	Price per Share	Shares	%	Post-Financing Value
You			600,000	30.0%	\$ 1,200,000
Investor 1	\$ 400,000		400,000	20.0%	\$ 800,000
Investor 2	\$ 2,000,000	\$2.00	1,000,000	50.0%	\$ 2,000,000
Subtotal			1,400,000	70.0%	\$ 2,800,000
Total			2,000,000	100.0%	\$ 4,000,000

Everything is in balance. The world is good.

### The Not-So-Good Second Round: Share Price Decrease

Alternatively, as time progresses, you and your company move forward. It's time to raise some more money. Unfortunately for you, you are in a business that venture capital investors shun. Only one expresses lukewarm interest. Finally, you extract a deal.

- The new investor offers to invest \$500,000 for 50% of your company.
- If 50% of the company is worth \$500,000, then the total company must be worth \$1,000,000.
- Since there are 1,000,000 shares outstanding today and they will represent 50% of the company after the financing, then the new investor is buying 1,000,000 shares.
- The \$500,000 investment divided by 1,000,000 shares yields a share price of \$0.50.
- Since I paid \$1.00 per share, I'm not happy. In fact, the 400,000 shares that I paid \$400,000 for are now worth \$200,000 (400,000 shares X \$0.50 per share).
- The value of my investment has been diluted.
- In addition, the percent of the company I own has decreased (been diluted) from 40% to 20%.
- By the same reasoning, your equity stake is now only worth \$300,000, and you've only got \$500,000 of investor's money to keep your business alive.

	Investment	Price per Share	Shares	%	Post-Financing Value
You			600,000	30.0%	\$ 300,000
Investor 1	\$ 400,000		400,000	20.0%	\$ 200,000
Investor 2	\$ 500,000	\$0.50	1,000,000	50.0%	\$ 500,000
Subtotal			1,400,000	70.0%	\$ 700,000
Total			2,000,000	100.0%	\$ 1,000,000

Everything is in balance. The world is not so good. I want some protection against this form of dilution.



**Recap**

Dilution has several meanings in deal making. It is critical to understand the context. An investor is most concerned about the value of his investment. If a proposed transaction will reduce the value of the investor's investment (a lower price per share than he paid), he will seek anti-dilution protection.



## Chapter 51

### Full Ratchet Anti-Dilution Protection: Fasten your Seat Belt

*By Frank Demmler*

In the last article, we discussed how the word “dilution” has several meanings in deal making. It is critical to understand the context.

An investor in any given round of financing is concerned that the next round could be at a lower price per share than what he is paying this round. Therefore, the investor will insist upon anti-dilution protection.

If pressed for justification, the investor may explain that if the value of a company declines between rounds, management must be largely responsible. The investor maintains that he shouldn't be penalized for management's deficiencies.

There are two common types of anti-dilution protection: full ratchet and weighted average.

This time we will examine full ratchet anti-dilution protection.

#### **Full Ratchet Anti-Dilution Protection**

As a practical matter [as compared to the legal language below], full ratchet anti-dilution protection gives the original investor rights to that number of shares of common stock as if he paid the current round's lower price.

I've tried to keep unnecessary complexity out of these articles, but it's unavoidable at juncture.

Investors purchase preferred stock that is convertible into common stock. Initially the conversion is on a one-to-one basis, or at the same share price as that paid for the preferred stock. Anti-dilution protection is implemented by adjusting the conversion price.

The language that is used in a term sheet to say this is:

In the event that the Company issues additional securities in the future at a purchase price less than the current Series A Preferred conversion price, such conversion price shall be adjusted in accordance with the following formula:

Full-ratchet – the conversion price will be reduced to the price at which the new shares are issued.

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Let's look at how this works.

#### **The First Round**

Let's review last week's example.

- I offer to invest \$400,000 in your company in exchange for 40% of it.
- Since you own all 600,000 shares of your company, I am offering to buy 400,000 new shares in order to acquire 40%.
- My investment of \$400,000 divided by 400,000 shares that I'm buying yields a per share price of \$1.00.
- Since you own 600,000 shares, that means the value of the stake in your company is \$600,000, which is the pre-financing value.



- Adding my \$400,000 to that yields a post-financing value of \$1,000,000.
- That is confirmed by taking the total number of outstanding shares, 1,000,000 (your 600,000 and my 400,000) and multiplying that by the share price of \$1.00.
- That also says that the post-financing value of your company is \$1,000,000.

	Investment	Price per Share	Shares	%	Post-Financing Value
You			600,000	60.00%	\$ 600,000
Investor 1	\$ 400,000	\$1.0000	400,000	40.00%	\$ 400,000
Anti-dilution protection			0	0.00%	\$ -
Investor 1 subtotal			400,000	40.00%	\$ 400,000
Investor 2			0	0.00%	\$ -
Investor subtotal			400,000	40.00%	\$ 400,000
Total			1,000,000	100.00%	\$ 1,000,000

There's one big difference this week. The terms of this deal include **full ratchet anti-dilution protection**.

## The Second Round

It's time to raise some more money. Unfortunately, the only investment offer you are able to attract is at a lower price per share than the prior round.

Without anti-dilution protection, the deal would proceed:

- The new investor offers to invest \$500,000 for 50% of your company.
- If 50% of the company is worth \$500,000, then the total company must be worth \$1,000,000.
- Since there are 1,000,000 shares outstanding today and they will represent 50% of the company after the financing, then the new investor is buying 1,000,000 shares.
- The \$500,000 investment divided by 1,000,000 shares yields a share price of \$0.50.
- Since I paid \$1.00 per share, I'm not happy. In fact, the 400,000 shares that I paid \$400,000 for are now worth \$200,000 (400,000 shares X \$0.50 per share).
- The value of my investment has been diluted.
- In addition, the percent of the company I own has decreased (been diluted) from 40% to 20%.
- By the same reasoning, your equity stake is now only worth \$300,000, and you've only got \$500,000 of investor's money to keep your business alive.



	Investment	Price per Share	Shares	%	Post-Financing Value
You			600,000	30.00%	\$ 300,000
Investor 1	\$ 400,000		400,000	20.00%	\$ 200,000
Anti-dilution protection					
Investor 1 subtotal			400,000	20.00%	\$ 200,000
Investor 2	\$ 500,000	\$0.5000	1,000,000	50.00%	\$ 500,000
Investor subtotal			1,400,000	70.00%	\$ 900,000
Total			2,000,000	100.00%	\$ 1,200,000

BUT I do have anti-dilution protection, so the deal will have needs to be adjusted.

### The Adjustment – Step #1

With anti-dilution protection, the deal would proceed:

- **The new investor offers to invest \$500,000 for 50% of your company.**
- If 50% of the company is worth \$500,000, then the total company must be worth \$1,000,000.
- Since there are 1,000,000 shares outstanding today and they will represent 50% of the company after the financing, then the new investor is buying 1,000,000 shares.
- **The \$500,000 investment divided by 1,000,000 shares yields a share price of \$0.50.**
- While I paid \$1.00 per share, the new round will reduce that price to \$0.50. So, in addition to the original 400,000 shares for which I paid \$400,000, **I will receive an additional 400,000 shares, bringing my total shares to 800,000** (\$400,000 divided by \$0.50 per share).

	Investment	Price per Share	Shares	%	Post-Financing Value
You			600,000	25.00%	\$ 300,000
Investor 1	\$ 400,000		400,000	16.67%	\$ 200,000
Anti-dilution protection			400,000	16.67%	\$ 200,000
Investor 1 subtotal			800,000	33.33%	\$ 400,000
Investor 2	\$ 500,000	\$0.5000	1,000,000	41.67%	\$ 500,000
Investor subtotal			1,800,000	75.00%	\$ 900,000
Total			2,400,000	100.00%	\$ 1,200,000

Done? Nope.

By issuing an additional 400,000 shares, the total number of shares has increased as well.

**The new investor would only own 42%** if we were to stop here, but we won't.



## The Adjustment – Step #2

Remember the first element of the deal:

- **The new investor offers to invest \$500,000 for 50% of your company.**
- If 50% of the company is worth \$500,000, then the total company must be worth \$1,000,000.
- Since there are 1,400,000 shares outstanding, including those created by my anti-dilution protection, the new investor must buy 1,400,000 shares to purchase 50%.
- **The \$500,000 investment divided by 1,400,000 shares yields a share price of \$0.36.**

	Investment	Price per Share	Shares	%	Post-Financing Value
You			600,000	21.43%	\$ 214,286
Investor 1	\$ 400,000		400,000	14.29%	\$ 142,857
Anti-dilution protection			400,000	14.29%	\$ 142,857
Investor 1 subtotal			800,000	28.57%	\$ 285,714
Investor 2	\$ 500,000	\$0.3571	1,400,000	50.00%	\$ 500,000
Investor subtotal			2,200,000	78.57%	\$ 642,857
Total			2,800,000	100.00%	\$ 857,143

Done? Nope.

## The Adjustment – Step #3

With the share price having dropped to \$0.36, my anti-dilution protection needs to be recalculated

- Since the price per share this round is \$0.36, in addition to the original 400,000 shares for which I paid \$400,000, **I will receive an additional 720,000 shares, bringing my total shares to 1,120,000** (\$400,000 divided by \$0.36 per share).

	Investment	Price per Share	Shares	%	Post-Financing Value
You			600,000	19.23%	\$ 214,286
Investor 1	\$ 400,000		400,000	12.82%	\$ 142,857
Anti-dilution protection			720,000	23.08%	\$ 257,143
Investor 1 subtotal			1,120,000	35.90%	\$ 400,000
Investor 2	\$ 500,000	\$0.3571	1,400,000	44.87%	\$ 500,000
Investor subtotal			2,520,000	80.77%	\$ 900,000
Total			3,120,000	100.00%	\$ 1,114,286

Done? Nope. Beginning to see a pattern?

## The Adjustment – Steps #4-?

When I get additional shares from anti-dilution protection, the investor's ownership drops to less than 50%.



The share price is reduced so that the investor is buying enough shares to own 50%.  
The lower price means I get more shares. That lowers the investor's share price. And on and on...

This why I learned to use the "Iterate" function in my spreadsheet.

### The Investor Outcome

The share price drops all the way to less than \$0.17.

The new investor buys 3,000,012 shares.

I get 2,000,010 shares as a result of full ratchet anti-dilution protection.

	Investment	Price per Share	Share s	%	Post-Financing Value
You			600,000	10.00%	\$100,000
Investor 1	\$400,000		400,000	6.67%	\$66,666
Anti-dilution protection			2,000,010	33.33%	\$333,334
Investor 1 subtotal			2,400,010	40.00%	\$400,000
Investor 2	\$500,000	\$0.1667	3,000,012	50.00%	\$500,000
Investor subtotal			5,400,021	90.00%	\$900,000
Total			6,000,024	100.00%	\$1,000,000

### Your Outcome

As you may have noticed, all of these adjustments have occurred to the investors' positions. What happens to you?

It isn't pretty. As the number of shares for the investors ratchet higher and higher, your number of shares remains constant at 600,000.

**Your share of your company has fallen to 10%!**

**The value of your shares has dropped to \$100,000!**

### Reviewing the Basics

Let's look at some of the relevant basics.

- Deals are negotiated with percentages, but are structured with shares.
- The value of a company is determined by multiplying the total number of common shares by the most recent share price.
- Price per share = Amount of investment divided by the number of shares purchased.

As I've said before, these may appear to be pretty dry and boring gobbledygook, but as we've seen, they can have very significant consequences.

### Recap

An investor in any given round of financing is concerned that the next round could be at a lower price per share than what he is paying this round. Therefore, the investor will insist upon anti-dilution protection.



Full ratchet anti-dilution protection is very friendly to the investor and is very harsh to the founder.



## Chapter 52

### Weighted Average Anti-Dilution Protection: Get Out your Calculator

*By Frank Demmler*

An investor in any given round of financing is concerned that the next round could be at a lower price per share than what he is paying this round. Therefore, the investor will insist upon anti-dilution protection.

If pressed for justification, the investor may explain that if the value of a company declines between rounds, management must be largely responsible. The investor maintains that he shouldn't be penalized for management's deficiencies.

There are two common types of anti-dilution protection: full ratchet and weighted average.

The last article examined full ratchet anti-dilution protection. This week we will look at weighted average anti-dilution protection.

#### Weighted Average Anti-Dilution Protection

Unlike full ratchet anti-dilution protection that is effectively a “do-over,” weighted average anti-dilution protection gives consideration to the relationship between the total shares outstanding as compared to the shares held by the original investor.

A reminder, investors purchase preferred stock that is convertible into common stock. Initially the conversion is on a one-to-one basis, or at the same share price as that paid for the preferred stock. Anti-dilution protection is implemented by adjusting the conversion price.

The legal language that is used in a term sheet to say this is:

In the event that the Company issues additional securities at a purchase price less than the current Series A Preferred conversion price, such conversion price shall be adjusted in accordance with the following formula:

$$CP_2 = CP_1 * (A+B) / (A+C), \text{ where:}$$

$CP_2$  = New Series A Conversion Price

$CP_1$  = Series A Conversion Price in effect immediately prior to new issue

A = Number of shares of Common Stock deemed to be outstanding immediately prior to new issue (includes all shares of outstanding common stock, all shares of outstanding preferred stock on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing)

B = Aggregate consideration received by the Corporation with respect to the new issue divided by  $CP_1$

C = Number of shares of stock issued in the subject transaction

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Let's look at how this works.



## The First Round

Let's go back to our example transaction.

- I offer to invest \$400,000 in your company in exchange for 40% of it.
- Since you own all 600,000 shares of your company, I am offering to buy 400,000 new shares in order to acquire 40%.
- My investment of \$400,000 divided by 400,000 shares that I'm buying yields a per share price of \$1.00.
- Since you own 600,000 shares, that means the value of the stake in your company is \$600,000, which is the pre-financing value.
- Adding my \$400,000 to that yields a post-financing value of \$1,000,000.
- That is confirmed by taking the total number of outstanding shares, 1,000,000 (your 600,000 and my 400,000) and multiplying that by the share price of \$1.00.
- That also says that the post-financing value of your company is \$1,000,000.

	Investment	Price per Share	Shares	%	Post-Financing Value
You			600,000	60.00%	\$ 600,000
Investor 1	\$ 400,000	\$1.0000	400,000	40.00%	\$ 400,000
Anti-dilution protection			0	0.00%	\$ -
Investor 1 subtotal			400,000	40.00%	\$ 400,000
Investor 2			0	0.00%	\$ -
Investor subtotal			400,000	40.00%	\$ 400,000
Total			1,000,000	100.00%	\$1,000,000

There's one difference this week. The terms of this deal include **weighted average anti-dilution protection**.

## The Second Round

It's time to raise some more money. Unfortunately, the only investment offer you are able to attract is at a lower price per share than the prior round.

Without anti-dilution protection, the deal would proceed:

- The new investor offers to invest \$500,000 for 50% of your company.
- If 50% of the company is worth \$500,000, then the total company must be worth \$1,000,000.
- Since there are 1,000,000 shares outstanding today and they will represent 50% of the company after the financing, then the new investor is buying 1,000,000 shares.
- The \$500,000 investment divided by 1,000,000 shares yields a share price of \$0.50.
- Since I paid \$1.00 per share, I'm not happy. In fact, the 400,000 shares that I paid \$400,000 for are now worth \$200,000 (400,000 shares X \$0.50 per share).
- The value of my investment has been diluted.
- In addition, the percent of the company I own has decreased (been diluted) from 40% to 20%.



- By the same reasoning, your equity stake is now only worth \$300,000, and you've only got \$500,000 of investor's money to keep your business alive.

	Investment	Price per Share	Shares	%	Post-Financing Value
You			600,000	30.00%	\$ 300,000
Investor 1	\$ 400,000		400,000	20.00%	\$ 200,000
Anti-dilution protection					
Investor 1 subtotal			400,000	20.00%	\$ 200,000
Investor 2	\$ 500,000	\$0.5000	1,000,000	50.00%	\$ 500,000
Investor subtotal			1,400,000	70.00%	\$ 900,000
Total			2,000,000	100.00%	\$1,200,000

**BUT** I do have anti-dilution protection, so the deal will have needs to be adjusted.

### The Adjustment – Scenario #1

With anti-dilution protection, the deal would proceed:

- The new investor offers to invest \$500,000 for 50% of your company.**

Let's enter the values for the variables in the weighted average anti-dilution formula:

$$CP_2 = CP_1 * (A+B) / (A+C), \text{ where:}$$

$CP_2$  = New Series A Conversion Price

$CP_1$  = \$1.00

A = 1,000,000

B = 500,000

C = 1,000,000

$$CP_2 = \$1.00 * (1,000,000 + 500,000) / (1,000,000 + 1,000,000)$$

$$CP_2 = \$1.00 * (1,500,000) / (2,000,000)$$

$$CP_2 = \$0.75$$

So, with my conversion price being reduced from \$1.00 to \$0.75, my 400,000 shares of preferred stock will convert into 533,333 shares of common stock. Weighted average anti-dilution protection has given me the rights to 133,333 shares of common stock.



	Investment	Price per Share	Shares	%	Post-Financing Value
You			600,000	28.13%	\$ 300,000
Investor 1	\$ 400,000		400,000	18.75%	\$ 200,000
Anti-dilution protection	\$0.7500		133,333	6.25%	\$ 66,667
Investor 1 subtotal			533,333	25.00%	\$ 266,667
Investor 2	\$ 500,000	\$0.5000	1,000,000	46.88%	\$ 500,000
Investor subtotal			1,533,333	71.88%	\$ 766,667
Total			2,133,333	100.00%	\$1,066,667

Are we done? Maybe. Maybe not.

- Deals are negotiated with percentages, but are structured with shares.

## The Adjustment – Scenario #2

Remember the first element of the deal:

- The new investor offers to invest \$500,000 for 50% of your company.

Does that mean before, or after, consideration of the shares associated with the anti-dilution protection? If the former, then the solution found above is correct.

If the latter, then we have to put the “Iterate” function of our spreadsheet to work again (as we did last week with full ratchet anti-dilution protection).

	Investment	Price per Share	Shares	%	Post-Financing Value
You			600,000	25.38%	\$ 253,846
Investor 1	\$ 400,000		400,000	16.92%	\$ 169,231
Anti-dilution protection	\$0.6875		181,818	7.69%	\$ 76,923
Investor 1 subtotal			581,818	24.62%	\$ 246,154
Investor 2	\$ 500,000	\$0.4231	1,181,818	50.00%	\$ 500,000
Investor subtotal			1,763,636	74.62%	\$ 746,154
Total			2,363,636	100.00%	\$1,000,000

This yields a transaction price per share of \$0.4231, instead of \$0.50. My conversion price has become \$0.6875, instead of \$0.75 and the number of common stock shares to which I have rights has increased from 533,333 shares to 581,818 shares.

## The Investor Outcome

The new investor buys 50% of the company (or almost 50%, depending upon the scenario that’s been selected).



I get rights to less than 200,000 shares of common stock as a result of weighted average anti-dilution protection. That's something, but pretty modest when compared to the 2,001,000 shares that resulted from full ratchet anti-dilution protection.

### **Your Outcome**

Just as in the case of full ratchet anti-dilution protection, all of these adjustments have occurred to the investors' positions. What happens to you?

It isn't pretty. As the number of shares for the investors ratchet higher and higher, your number of shares remains constant at 600,000.

**Your share of your company is in the range of 25-30%, compared to 10% with full ratchet!**

**The value of your shares has dropped to less than \$300,000, which is better than \$100,000 in the full ratchet case! You have paid a price for the down round, but not to the extreme of full ratchet anti-dilution protection.**

### **Recap**

An investor in any given round of financing is concerned that the next round could be at a lower price per share than what he is paying this round. Therefore, the investor will insist upon anti-dilution protection.

Weighted average anti-dilution protection is more friendly to entrepreneur than full ratchet anti-dilution protection.

Next week we'll look at the practical implications of the forms of anti-dilution protection.



## Chapter 53

### Anti-Dilution Protection Postscript: At the Risk of Beating a Dead Horse...

*By Frank Demmler*

Let's summarize where we've been in recent weeks.

An investor in any given round of financing is concerned that the next round could be at a lower price per share than what he is paying this round. Therefore, the investor will insist upon anti-dilution protection.

In recent weeks, we have discussed the two common types of anti-dilution protection: full ratchet and weighted average. In the event that the current round of investment is at a lower price per share, then:

- Full ratchet anti-dilution protection gives the original investor rights to that number of shares of common stock as if he paid the current round's lower price.
- Weighted average anti-dilution protection gives consideration to the relationship between the total number of shares outstanding compared to the number of shares held by the original investor.

You will prefer weighted average anti-dilution protection to full ratchet.

While I know that several readers will not believe this, but what I've done in prior weeks is to try to simplify the calculations involved in the explanations of the various forms of anti-dilution protection.

This week I will introduce one of the primary components of complexity – the treatment of stock options.

#### **Fully Diluted Basis**

The strict definition of fully diluted basis is:

Number of shares of Common Stock deemed to be outstanding immediately prior to new issue (includes all shares of outstanding common stock, all shares of outstanding preferred stock on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing).

In essence, an investor will phrase the terms of his investment as being calculated on a "fully diluted basis," by including shares of common stock that are not currently outstanding, but the company is obligated to issue them based upon existing agreements (convertible preferred stock, options, etc.). The inclusion of these numbers in the share base can significantly impact the resulting outcomes.

Let's take a look at how option pools can impact full ratchet anti-dilution protection.

#### **The First Round**

Let's review the example that we've been using in this series of articles.

- I offer to invest \$400,000 in your company in exchange for 40% of it.
- Since you own all 600,000 shares of your company, I am offering to buy 400,000 new shares in order to acquire 40%.



- My investment of \$400,000 divided by 400,000 shares that I'm buying yields a per share price of \$1.00.
- Since you own 600,000 shares, that means the value of the stake in your company is \$600,000, which is the pre-financing value.
- Adding my \$400,000 to that yields a post-financing value of \$1,000,000.
- That is confirmed by taking the total number of outstanding shares, 1,000,000 (your 600,000 and my 400,000) and multiplying that by the share price of \$1.00.
- That also says that the post-financing value of your company is \$1,000,000.

	Investment	Price per Share	Shares	%	Post-Financing Value
You			600,000	60.00%	\$ 600,000
Stock Option Pool			-	-	-
Management subtotal			600,000	0.00%	\$ 100,000
Investor 1	\$ 400,000	\$1.0000	400,000	40.00%	\$ 400,000
Anti-dilution protection			-	-	-
Investor 1 subtotal			400,000	40.00%	\$ 400,000
Investor 2			-	-	-
Investor subtotal			400,000	40.00%	\$ 400,000
Total			1,000,000	100.00%	\$ 1,000,000

The terms of this deal include **full ratchet anti-dilution protection** for me.

## The Second Round

It's time to raise some more money. Unfortunately, the only investment offer you are able to attract is at a lower price per share than the prior round.

- The new investor offers to invest \$500,000 for 50% of your company. Since I have full ratchet anti-dilution protection; that has to be included in the calculations.

	Investment	Price per Share	Shares	%	Post-Financing Value
You			600,000	10.00%	\$ 100,000
Stock Option Pool			-	-	-
Management subtotal			600,000	10.00%	\$ 100,000
Investor 1	\$ 400,000		400,000	6.67%	\$ 66,666
Anti-dilution protection			2,000,010	33.33%	\$ 333,334
Investor 1 subtotal			2,400,010	40.00%	\$ 400,000
Investor 2	\$ 500,000	\$0.1667	3,000,012	50.00%	\$ 500,000
Investor subtotal			5,400,021	90.00%	\$ 900,000
Total			6,000,024	100.00%	\$ 1,000,000



As I noted in the original article, the full ratchet anti-dilution protection creates a pretty ugly outcome for you.

### The Investor Outcome

The share price drops all the way to less than \$0.17.

The new investor buys 3,000,012 shares.

I get 2,000,010 shares as a result of full ratchet anti-dilution protection.

### Your Outcome

All of these adjustments have occurred to the investors' positions. What happens to you? It isn't pretty. As the number of shares for the investors ratchet higher and higher, your number of shares remains constant at 600,000.

**Your share of your company has fallen to 10%!**

**The value of your shares has dropped to \$100,000!**

### But...

As a practical matter, the investor in Round 2 would not do the deal without a provision for a management option pool. Let's say that the investor call for a 9% pool. That gives us several values for variables that will allow us to calculate the resulting capitalization table.

- You own 600,000 shares of common stock.
- I have invested \$400,000 with full ratchet anti-dilution protection.
- The new investor has agreed to invest \$500,000 for 50% of the company on a fully diluted basis after provision for a 9% option pool.

Let's take a look at the outcome.

	Investment	Price per Share	Shares	%	Post-Financing Value
You			600,000	1.00%	\$ 10,000
Stock Option Pool			5,400,000	9.00%	\$ 90,000
Management subtotal			6,000,000	10.00%	\$ 100,000
Investor 1	\$ 400,000		400,000	0.67%	\$ 6,667
Anti-dilution protection			23,600,000	39.33%	\$ 393,333
Investor 1 subtotal			24,000,000	40.00%	\$ 400,000
Investor 2	\$ 500,000	0.0166667	30,000,000	50.00%	\$ 500,000
Investor subtotal			54,000,000	90.00%	\$ 900,000
Total			60,000,000	100.00%	\$ 1,000,000

### The Investor Outcome

The share price drops all the way to less than \$0.02.

The new investor buys 30,000,000 shares.

I get 23,600,000 shares as a result of full ratchet anti-dilution protection.

### Your Outcome

All of these adjustments have occurred to the investors' positions. What happens to you?



It is pretty ugly. As the number of shares for the investors have ratcheted higher and higher, your number of shares remains constant at 600,000.

**Your share of your company has fallen to 1%!**

**The value of your shares has dropped to \$10,000!**

## Reviewing the Basics

Let's look at some of the relevant basics.

- Deals are negotiated with percentages, but are structured with shares.
- The value of a company is determined by multiplying the total number of common shares by the most recent share price.
- Price per share = Amount of investment divided by the number of shares purchased.

As I've said before, these may appear to be pretty dry and boring gobbledygook, but as we've seen, they can have very significant consequences.

## Recap

An investor in any given round of financing is concerned that the next round could be at a lower price per share than what he is paying this round. Therefore, the investor will insist upon anti-dilution protection.

An investor will invest on a fully diluted basis.

Avoid any deal that has a non-diluted fixed percentage of the equity.

If that's unavoidable, at least negotiate for conditions under which that restriction goes away.

Well, that's about it for anti-dilution protection. Next time we'll move on to something else. Whew!



## Appendix 1

### 2004: A Step in the right Direction?: The numbers are better, but that's not saying much

*By Frank Demmler*

The numbers are coming in and 2004 was better than 2003 in most respects. Of course, 2003 wasn't much to write home about.

According to figures recently released by the National Venture Capital Association (NVCA), the highlights are:

- Venture capital funds raised \$17.6 billion in 2004, up from \$10.6 billion in 2003.
- Venture capital funds invested \$20.9 billion in portfolio companies, up from \$18.9 billion the prior year.

Let's put this into some perspective.

### Venture Capital Flow of Funds

Venture capital firms manage venture capital funds. Let me explain.

1. A group of people gets together and decides to go into the venture capital business together. They create a firm.
2. This firm then becomes the general partner of a limited partnership. The limited partnership is the proposed venture capital fund.
3. They hang out a shingle and announce that they are raising a venture capital fund of some targeted amount.
4. If everything goes according to plan, they then raise money for their venture capital fund, primarily from institutional investors, such as pension funds and insurance companies.
5. With their venture capital fund in place, the venture capitalists make investments in portfolio companies.
6. The portfolio companies are sold or they go public.
7. The proceeds from these transactions are distributed to the investors.
8. If the investors are pleased with the results, the venture capital management company (the firm) will seek investment into a new limited partnership, designated with Roman numeral II. (Actually, follow on funds are often raised
9. And so it goes.

For example, Adams Capital Management, manages three venture capital funds ACM I, ACM II and ACM III that total over \$700 million.

### Capital Raised by Venture Capital Funds

OK, so the process starts with venture capitalists raising money from institutional investors. Where does \$17.6 billion fit in the overall scheme of things? Let's take a look at the high and low points of recent years.

1989	Peak	\$5.6 billion
1991	Trough	\$1.7 billion
1994	Rebound	\$7.6 billion
1998	Internet infancy	\$29.4 billion



2000	Internet BOOM	\$106.1 billion
2002	Internet BUST	\$3.7 billion
2004	Return to normalcy?	\$17.6 billion

Let's say it's encouraging. The extreme swings of recent years, and their consequences, have caused a suspension of "normal" behavior by venture capital funds, particularly in their avoidance of early stage companies.

### **A Look Behind the 2004 Numbers**

Almost 75% of the capital raised went into follow on funds (Roman numerals), meaning that it is still extremely difficult for new partnerships to get traction with institutional investors. For entrepreneurs, that means that the universe of potential investors aren't likely to have changed, but perhaps they will have new funds from which to invest. Locally, Draper Triangle had an initial closing on its second fund in 2004, and PA Early Stage closed its third fund and opened an office in Pittsburgh. Let's hope that other venture capitalists are successful in raising new funds in 2005.

Venture capitalists invested:

- \$20.9 billion in 2,876 deals;
- in 796 companies receiving first-time venture capital investment across all stages, of which early stage companies were a subset;
- in 841 deals in companies classified as early stage by the NVCA, meaning that many of these investments were follow on investments in existing portfolio companies; and
- 27% of the capital in Life Sciences companies, near the industry's all time high.

I leave it to you to decide whether you think things have improved appreciably.

### **Regional Musings**

It's pretty sobering when you think about the size of the Pittsburgh Region in the context of these national statistics. Overall, we're probably behind our "fair share" of venture capital, deals and invested capital. Yet our collective aspirations require us to exceed our pro rata share, by a significant margin. We've got our work cut out for us.



## Appendix 2

### About Frank Demmler

## L. FRANK DEMMLER

Adjunct Professor of Entrepreneurship

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#### Education:

- Princeton University - B.S.M.E. - 1971
- University of California at Los Angeles - M.B.A. - 1973
- Post-graduate Studies in Marketing, Harvard Business School, 1973-1975 - - 1975

#### Teaching and Research Interests:

- Transformation of entrepreneurial interest into action; optimal mix of scarce resources to create enterprise value; the dynamic relationship between execution options and capital availability; commercialization of technology; role of entrepreneurship in economic development.

#### Awards:

- First recipient of the Gerald E. McGinnis Adjunct Professor of Entrepreneurship, Carnegie Mellon University - 1998-2000
- Regional Finalist, Ernst & Young Entrepreneur of the Year, Supporter of Entrepreneurship - 1997

#### Consulting:

- Merging business and funding strategies; prioritization of execution actions; creating focus and urgency
- Advisory relationships of all types with almost 3,000 early stage enterprises, their founders, and key management in over 20 years; direct participation in hundreds of investment transactions from both sides of the table totaling about \$500 million of cumulative funding. You name it and Iâ€™ve done it, or know someone who has

Further Information at: [http://business.tepper.cmu.edu/display\\_faculty.aspx?id=168](http://business.tepper.cmu.edu/display_faculty.aspx?id=168)