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# REPORT ON BUSINESS

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

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## The 5 Worst Things to Say to a Potential Investor



**SEAN WISE**  
WISE WORDS

Don't worry, I'm not about to insult you, but remember what Yo' Momma said?

*"You only get one chance to make a good first impression."*

But when it comes to startup finance, the phrase should be "You only get one chance to make a bad first impression", because in the world of investment, certain utterances can make a bad first impression and kill your deal. These deal killing phrases are often known as "Red Flags". According to everyone's favorite open source community-based encyclopedia, Wikipedia:

*Red Flag* as in *waving a red flag* is a euphemism for incitement (see bullfighting), and red is the "colour of defiance." In the same vein, a signal of danger or a problem can be referred to as a red flag

It is this last definition I'd like for us to focus on. During the oh so important "first date" between capital seeking founder and potential funder, investors vigilantly watch for "Red Flags" - warning signs that the entrepreneur is out of their depth, lying, or simply doesn't know what he or she is talking about. Uttering

any of these phrases is a sure sign of a lack of business acumen, and makes it all too easy for the potential investor to walk away from your "opportunity".

As mentioned in earlier columns, Venture Capitalists are actually in the business of saying "No". VCs typically meet hundreds of capital seeking entrepreneurs annually, but most investors only write 2 or 3 cheques a year at most. Entrepreneurs can therefore make an investor's life easy by uttering one of any of the following five key phrases - "Red Flags" if you will:

1. We have no competition
2. Our financial projections are (and/or valuation is) conservative
3. We know more about (software/search/media) than (Microsoft/Google/Fox)
4. This will be our last round of funding
5. If we only get 1% of the market, then we will all be rich

Let's explore each individually to see why these are such turn-offs in the dating life of investors.

**We Have No Competition**

Everyone has competition, and that's not so terrible according to Barry Gekiere, Senior VP for Ventures West, and one of the most respected investors in the venture capital business today: "Competition isn't a bad thing, because if you really have no competition, then it could be because the problem you are addressing is not important enough".

Try to remember - there are four main forms of competition:

- direct
  - indirect
  - alternative, and
  - status quo;
- and each can divert sales from your venture.

Let's use this example to illustrate each of these: Say you have a teenage daughter who loves playing soccer. One day she comes home and asks you to buy her a new pair of Nike soccer shoes for \$325. Assuming you don't want to spend \$325 on a pair of shoes that she will grow out of in less than a year, you will have to look at the competition for those Nikes. Let's use this example to illustrate each of these: Say you have a teenage daughter who loves playing soccer. One day she comes home and asks you to buy her a new pair of Nike soccer shoes for \$325. Assuming you don't want to spend \$325 on a pair of shoes that she will grow out of in less than a year, you will have to look at the competition for those Nikes. Let's take them one at a time.

First, you could go with a direct competitor, say Reebok - same quality, same cost, but different brand. No help there, since the prices are also comparable. Or, you could go with an indirect competitor, say a knock-off brand, not as good as the Nike's, but still potentially satisfying your daughter's need for new shoes. The next choice you could make is to go with an alternative, say convince her to take up swimming. Not sure that will fly, but it is a possibility. Finally, you could ask her to use the pair of running shoes she uses for gym class, thereby sticking with the status quo. It is this last type of competition that kills more startups than the others, and it is this last type that Gekiere says most entrepreneurs overlook:

*"Notwithstanding what an entrepreneur thinks, there is always competition, and the toughest form of competition can just be having the prospective customers maintain the status quo. You can't overlook this option, yet so many do."*

In the end, competition is more about the choices your customers have than other companies who are producing similar products. So when a pitcher says, "we have no competition", an investor immediately thinks one of two things:

- (1) This person doesn't know how to use Google; or
- (2) This problem isn't worth solving.

Neither serves your interest, and both give the investor an easy way to say "No".

**Our Financial Projections are (and/or Valuation is) Conservative**

Projections by definition are just that - "best guesses" on a future state. Entrepreneurs, by their very nature, are passionately optimistic about their venture's potential success - otherwise they wouldn't sacrifice so much. This causes their projections to be anything but conservative. In fact, what entrepreneurs should really be saying is, "this is our best guess based upon what our competition has done, and what we hope we can do." (Note: I sat in on a presentation where a founder actually said this, and believe it or not, the

investors chuckled and appreciated it).

Saying your estimates are conservative only undermines an investor's confidence in your ability to see the world as it really is, not as you would like it to be. The same goes for valuation. Entrepreneurs tend to be overly optimistic when it comes to pricing their equity. Otherwise, how, after only investing \$100k and 6 months' time could the company be worth \$5 million? This is what bugs uber-investor and investment media guru, Kevin O'Leary:

*"The thing that pisses me off most about pitches is when the entrepreneur values his pre-revenue startup at \$10M. I mean, I've seen this movie before and I know how the movie is going to end. They get my money, and I get worthless stock."*

So, while you may feel your projections and valuations are conservative, know that this is an extremely subjective view, and one that investors won't necessarily agree with. Instead, just present the numbers and let the investors judge for themselves just how conservative they are.

**We Know More About (Software/Search/Media) than (Microsoft/Google/Fox)**

Investors from coast to coast chuckle when naive founders make statements on how the incumbents are too slow/big/dumb to beat them. When investors hear this, they can't help but think, "if that's the case, then why are they (Microsoft/Google/Fox) making millions while you (a teenee tiny startup) can't land one customer?"

Not to beat this point to death, and acknowledging that is, in fact, possible for a startup to have a better solution than a Fortune 500 incumbent (e.g. Google vs. Alta Vista or more recently YouTube vs. Google Video), you will need to provide objective third party evidence to validate this - not just hyperbole and wishful thinking. So, instead of just hoping they take your "red flag ridden" word for it, I suggest you provide validation of your claims by showing direct compressions (e.g. number of videos viewed), and letting potential investors draw their own conclusions.

Provide the investors with information as to why your solution is 10x better/faster/smaller/more cost efficient, and then provide them with substantial proof as to why it would be difficult for the incumbents to replicate what you are undertaking.

**This Will Be Our Last Round of Funding**

Entrepreneurs are notorious for underestimating both the capital and the time it takes to establish a presence in (let alone dominate) a market. Investors know this. In fact, it is not uncommon for investors to set aside 3x their initial investment commitment to a startup to ensure that the venture has the runway needed to achieve the goals agreed upon. So what do investors think when they hear this red flag? I asked David Raffa, Partner with BC's Lions' Capital about that, and this is what he had to say:

*"I want to know two things - how much money do they need for 18 months, and how much do they need to get to breakeven. The thing I know for sure is that they will run out of money faster than they think, and it will take them a lot longer to get to breakeven. I'll do my own math once they give me theirs."*

**If We Only Get 1% of the Market, Then We Will All Be Rich**

Nothing scares investors more than hearing the above statement. In fact, if anything epitomizes the dot.com boom, it was "if only we get 1% of the market share".

Truth be told, when calculating your total addressable market (aka "TAM"), this top down market analysis demonstrates management's lack of business acumen and extreme level of naiveté. I mean, does Nike say their market is 1% of everyone who has feet? I don't think so. So, abandon this top down math, and instead turn your mind to the infinitely more reasonable methodology of bottom up analytics.

Today, investors look for bottom up sales figures, not top down wishful thinking. First, determine your venture's average revenue per user (aka "ARPU"). Then, determine how many clients one salesperson can, on average, sell to during a period of time. Finally,

determine how many sales people you can deploy. When taken en masse, you will have a more accurate estimate of your revenue potential than you would when guessing how many "people with feet" will buy your shoes.

$$\text{ARPU} \times (\# \text{ of clients sold per year by a salesperson}) \times (\# \text{ of salespeople}) = \text{TAM}$$

**The Bottom Line**

Venture Capitalists hear approximately 300 deals each year. But only 2-3 will receive the capital they need to succeed. So why do investors file some opportunities in the Garbage file under "G"? For many reasons, not the least of all being the utterance of any of a series of well known, "Red Flags" - grandiose, ill-thought out, and sweeping statements that all investors' ears are vigilantly trained to strategically catch...and quickly show the door to those who dare speak them.

So if you are a founder seeking capital, take heed to banish these statements from your pitches. Doing so won't get you a deal, but failing to do so will make it easier for investors to file your deal under "G".

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Sean speaks at more than 20 Entrepreneurial Boot-camps and events across North America annually. Sean is the online host and industry advisor for CBC's hit business reality show www.INSIDetheDRAGONSden.com

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