THE KEMBALL GROUP

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The Dog's Bark

Report From the Startup Grind

July 31, 2013

David Rose, President of GUST

Pitch the investment, not the product.

The Capital Angel Network in Ottawa sponsored the appearance of David Rose, President of GUST, at a Start-up Grind Event on July 31 2013. Two of the Capital Angel Network members in attendance, Jennifer Francis and Peter Kemball, prepared the following summary of David's talk.

David Rose's Key Takeaways

1. **Make sure the product or service aligns with a customer problem that the customer is willing to spend money on now to fix.** Entrepreneurs, especially younger ones, do not have the experience in the industry to understand the pain that they are alleviating or whether there are great buyers with good credit willing to spend to solve that problem now. Yes, technology proficiency offers boundless opportunities, but they will only create wealth if aligned with real pain that needs to be addressed now.

2. **It's an investment pitch, not a product pitch.** Angels invest as part of their overall financial strategy. Entrepreneurs looking for angel investment need to demonstrate financial acumen and growth potential.

3. **Returns are sought by angels.** Generally, angels are looking for 30 times investment in six years. If you don't target this then you don't make enough to

Don't pitch to angels if you have not invested in your own idea. The Money Chase starts with your own cash injections, followed by those from friends and families, and then from angels.

make it worthwhile. {A 30 times return attained in six years post investment yields an IRR of 76% and seven years yields an IRR of about 63%. This makes sense from a portfolio perspective if you expect to lose all capital on six of ten deals. The result would be if all investments were of equal size an IRR of 47%, fifteen times on total capital employed, and a realistic portfolio return of 30%, about the minimum to make it worthwhile to do such investments.}

4. **Most companies do not show how they will create enough wealth to warrant angel investment.** Only 1 of 40 or 2.5% who seek angel financing get it, and only about 1 of 400 or .25% get venture capital.
5. **The Money Chase starts with your own cash injections followed by friends and family, and then angels.** Why would an angel invest in your company if you and those who know you best won't?
6. **Angels don't invest a lot individually.** A typical investment is $25,000 for an angel, so it would take 30 angels to raise $750,000.
7. **Technology advances have reduced the need for capital.** Technology has automated many tasks, reducing the need for staff, changing marketing tactics to a less costly online world and so on, and in turn reducing the amount of capital needed.
8. **East and west are different.** Silicon Valley is the home of The Big Dream but NYC is the home of applications to real world industry pains. {Inference here is that those seeking funding should seek funds from NYC if the pain relieved is "corporate" and organizational. The challenge for Canadian entrepreneurs is that the cross-border world is difficult. That said, the climate is slowly changing and while angels largely invest locally, NYC angels have 50% of deals outside NYC. This will change will speed up over time as investors such as VCs invest in other countries. David has one in Peru.
9. **Money is not the only investment of value.** Take half the valuation from smart money even if you have a bigger offer from dumb money.
10. **Angel and crowds invest from different pockets.** Angels take the money from their investment account. The crowd takes it from their discretionary spending account. For entrepreneurs, the real game is getting funds from accredited investors, those who have met the Securities Commission's definition and thus are allowed to invest in private companies. {What is interesting is the alteration in the definition proposed by an Ontario investor protection organization, FAIR. Accreditation would be keyed to knowledge of investing, not as now the presumed capacity to absorb the loss of the investment. The impact would be to expand the number of people active in the angel community. Membership in the community now effectively is tied to being an accredited investor under the current rules.}
11. **Convertible preferred shares can help ease a deal**. Easing a deal with convertible shares helps address conflicts over valuation. Unless there is a cap on the subsequent conversion valuation, e.g. the correct valuation at the time of angel investment, angels are at risk of overpaying. A 20% discount to a subsequent round valuing the firm at $5M does not make sense if the valuation at the time of the angel round was $2M.

Entrepreneurs and angels alike would do well to consider how the business will generate wealth earlier in the process.

David Rose then went on to discuss two major areas that are of abiding interest to entrepreneurs and investors alike: what do angels look for and what's the ideal pitch:

Angels look for certain qualities when assessing a company:

a. **Integrity** – there are going to be hard times and the cost of worry about the integrity of the principals is not worth it. How have they treated others to whom they have had a financial obligation?
b. **Domain knowledge**. If the entrepreneur does not understand the pain, then their solution will be wrong. What is on their resume relevant to the pain they are going to alleviate?
c. **Does the entrepreneur realize that taking other people's money is a game changer?** Quitting is not an option when you have agreed to manage other people's money, particularly when it is their personal money.
d. **What angels know and like is what they invest in.** Are you pitching to angels who have invested in companies in a similar space or with a similar model. Before pitching, match the angel to your opportunity.
e. **Is the entrepreneur actually an entrepreneur?** Some people are builders and leaders: they are just that way. Work history and for younger people evidence in other roles helps provide an answer.

While there is no cast-in-stone sequence, David's preferred pitch follows this outline:

a. What do you do – one sentence
b. What is the pain and whose is it?
c. How do you solve the pain?
d. How do you make money solving the pain? This is the business model.
e. Why are you the folks to solve it? This is about implementation. {If this is the key strength, put it earlier in the pitch.}
f. Do not mention valuation unless you have a signed term sheet from a lead investor.

Our Bark: The Kemball Group's Opinions

1. **Wealth creation should be assessed earlier rather than later**. We suggest that angels with their supporting casts of advisors and entrepreneurs would all be better off were the wealth creation potential of a venture be assessed early in the process. Likewise, wise entrepreneurs and their advisors should ensure that the proposed business model holds out the possibility of generating competitive levels of IRR before seeking angel investors. If they did this, entrepreneurs would avoid wasting months of their time in pursuit of the unattainable. Such an approach would also allow supporting groups, such as Regional Innovation Centers in Ontario, to provide better direction to their clients. Angels would see far fewer but higher potential deals and thus find it worth spending more time on each one.

2. **Our take on a pitch sequence is different from David's.** Because it is an investment pitch, not a product pitch we prefer the following order:

Download a free copy of Bill Payne's *The Definitive Guide to Angel Investing* at www.gust.com

a. Starts with a clear statement of the amount needed to get to a sustainable positive cash flow, typically between $250,000 and $1,000,000.
b. Affirms that the business can afford an IRR north of 60% and still create a level of wealth satisfactory to founders and employees.
c. Proposes a specific strategy to provide angels a return of capital and a return on capital.
d. Tests investor interest within 3 minutes of the start of the meeting by asking if they are interested in learning how the firm and its founders propose to manage the money to create wealth and stresses why its founders and employees will be good money managers.
e. Concludes by asking for help from the assembled angels in building the deal so that a term sheet can be circulated beyond those present.

3. **Shape angels' exit expectations.** Within the angel community, the predominant exit expectation is that they will make their money from the sale of the business to another firm. Not only did David Rose make this clear, Chapter 3 of Bill Payne's widely disseminated *The Definitive Guide to Angel Investing* makes clear the consequence of receiving angel funding.

> *"Entrepreneurs must recognize that investors are not funding their company to help the entrepreneur build the company as fast and as far as the entrepreneur can build it. The investor's objective is to quickly scale the company to a size and level of profitability that a larger company will be interested in acquiring their company."*

The guide's point of view is reinforced by two widely taught approaches to placing a value on the business so that the investors' target returns are feasible at exit, the Risk Weighted and Scorecard methods. Both are means to guide angels to avoid paying too much.

Four systematic, unintended and undesirable consequences flow from the prevailing exit mindset:

1. Opportunities that are not amenable to early exits are not funded;
2. The pool of entrepreneurs deemed capable is limited to sprinters;
3. Angel investors' individual transactions are less likely to be successful; and
4. Conflict between angels and entrepreneurs on valuations is certain because most exits are less than $15,000,000.

Our view is that angel investing could become an even greater source of wealth-creating capital by expanding its prevailing mindset to encompass liquidity beyond the one-time exit.

We suggest that entrepreneurs ask themselves whether or not they want to own, build and operate the business for a decade or two. Angels should also ask themselves whether or not they would accept an ongoing multi-decade revenue stream from a profitable business as an exit from some or all of their investments.

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We commented at the Angel Capital Annual Meeting in Austin, Texas that angel investing was half movement, half investing and half done. A change of mindset offers the prospect of removing the third half.

The Kemball Group *focuses on high-growth Canadian entrepreneurs who want to sustain 20% plus year-over-year growth for 10 years or more. We help these Canadian innovators beat the odds in building highly successful businesses, without giving up control.*

We offer entrepreneurs investment banking services in the private equity market place including our angel financing program.

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