"Financing for Your Startup – You Got to Tell a Story"

Dr. E. Ted Prince
Founder and CEO
Perth Leadership Institute
www.perthleadership.org
Top Capital Magazine (Beijing)
July 2012

I have written a lot of articles about funding a company during my life. I have read even more stories about how to get funding. Most of them are really boring. They will tell you a list of steps you need to do to get financing and they tell you about some of the very technical details involved in getting your funning. But I don't want to write yet another boring article just about funding. Instead I want to also tell you about the non-technical side of getting financing for your startup.

What I am going to tell you about is stories.

Before you even try to look for funding, you need to have a story about your startup. Not a made-up story of course. But a story that captures the essence of what is exciting about your startup and which captures your excitement the excitement and passion of your employees, partners and clients, and the powerful energy that this story has created in anyone who comes in contact with you and your startup.

It is this excitement that drives your funding initiative. The higher the level of excitement, the more money you will get and the easier the terms of the money that you receive.

For me, all the technical details of a financing stem from the strength of your story. If your story is good it will have a powerful impact on your valuation and thus how expensive or cheaply you get this money.

So the story has to possess the right elements to support your funding initiative. Conversely if you try to get funding relatively cheaply, if you don't have a story or your story line doesn't support the funding terms you really want, then you will find it difficult or impossible to get funding, or to get it at the price that you want.

Who Will Fund You?

There's a romantic idea that that a professional investor such as a venture capitalist is the first place you should go to get financing for your startup. Maybe that is possible for one in a thousand startups. In all probability it won't be you or your startup.

That is because professional investors and venture capitalists have strict rules about how much revenue you already have, how fast you must be growing, and how high your gross margin should be. Venture capitalist reject 95% of the plans put to them so statistically it is very unlikely you get money from them, at least not in the early stages of your startup.

The overwhelming chances are that you will get your first round of financing from friends and family (F&F). That's where 95% of startups get their money from. These people are not professional investors usually and they have radically different aims in investing in you.

Usually they are not investing in you simply because of your idea although of course you have to have an idea and it should be a good one. Most of the time it's precisely because you are a

friend, or someone in the family that they will invest in you. Sometimes it will be a friend of the family who knows you. In most cases the people who will invest in you will be older because most young people don't have enough money to help you yet because they haven't made their riches yet, that is, if they ever will.

So your most likely target as an investor is an older man or woman who already has a lot of money. They are investing not mainly because they think you are going to succeed but because they have a relationship with you or your parents or with another family member. With a professional investor you need lots so analysis and spreadsheets. F&F people generally aren't particularly interested in them, either because they just don't trust plans and spreadsheets or they believe that most investments don't pay off and they think you will be no different.

That's where the story comes in. A powerful vision and story is a must for these people. The story must show something important or uplifting that can help society, business, or especially the investor himself.

And not just in money terms. If the investor is older, maybe retired, often they are looking for something to get involved in, something to add excitement to their own life, to provide them with new and exciting directions that can refresh their own interest in life, and maybe appear more important to their own friends and family. They may well be prepared to invest in your startup even if they don't think it will succeed because if offers them a new interest for their life.

So in crafting your story, you need to know whom you are marketing to. What are the potential investor's interests? What are his or her hobbies, aims, activities, aspirations? How can you integrate your own powerful and exciting story with the interests, passions and activities of the potential investor in such a way that their own lifestyle and life is improved and more exciting?

Believe me, I have seen numerous investors who have invested a lot of money in startups that they never believed would succeed but that offered them a chance to add meaning, passion and excitement to their own life. They never made any money from these startups. But on the other hand they never expected to. Their reward was psychic and emotional, not monetary. If you have plenty of money already, sometimes you don't mind losing a little if it improves the quality and meaningfulness of your life.

With these types of investors, it isn't enough just to show them that your investment might make a lot of money. They are seeing business plans and proposals every day that promise them the same thing. Probably most of those plans and startups are better than yours.

So your point of differentiation is to show the potential investor how your startup is going to change their life, give it more meaning, extend their own interests, play to their passions, and maybe appear to be more important, visionary, powerful and exciting to their own colleagues and friends.

The Web Gives You a New Way of Raising Funding!

As always the web is changing things again for startups seeking money. There are now websites where you can put your idea online and look for funding for small amounts from private investors. In this case they are not necessarily F&F. Instead they are probably total strangers.

This is called "crowdsourcing". That means using the crowds of people of the internet to seek ideas and support. These sites allow you to crowdsource the job of finding financial support.

In the US the website Kickstarter has become famous for crowdsourcing startup funding. There is no doubt many more sites like this will start up. No doubt they will start to specialize, probably by industry, deal size and location.

Of course there are advantages and disadvantages. The advantage is that you extend enormously the potential investors for your company. The disadvantage is that they are strangers. You don't know them at all. Maybe there are trust and honesty issues. Maybe just personality conflicts.

And of course, these people have no interest in you as a person. They don't have a relationship with you. So you might not be able to rely of them for other types of support.

For crowdsourcing your story becomes even more important. These people don't know you at all so the story is really all they have because you won't have any record of success to show to them. They won't believe your financials because they don't know you. So now the story has got to be big and exciting enough to appeal to people who don't k now you at all.

But Kickstarter and sites like this are a dramatic new way of finding money. You need to check this out as well as using F&F.

How you're Story Impacts Your Deal Terms

Of course we are not assuming that your potential investors won't look at a business plan or a spreadsheet. And usually, even if they don't believe any of your financial projections, they will at least want to see them, if only to see how realistic or otherwise you are being. And some might still believe that you have a potential Facebook if you do the plan right. Just remember that most investors won't believe the story because they have seen hundreds of similar ones.

When you are doing your financial projections one of the major financial metrics that the more savvy investors will look at is your gross margin. If you don't know what that is, and many startups and founders don't, you better find out quickly. Because your gross margin is one of the quickest ways an investor can get a handle on how promising your startup could be.

If you have gross margins in the 60s or more, that could be a sign that you are onto a big idea that others aren't. If the gross margin is low, say around 10-20% it probably means that you are not working with a really new idea and that your chances of success are even lower than they thought.

Of course, there are startups that will project a low gross margin, ouch as Amazon and probably a company such as DangDang. However if you project such a low gross margin you are going to have to demonstrate to them that you will make your profits because you will achieve huge internet distribution with millions or hundreds of millions of users.

That's a hard thing to show for most investors and most are not going to believe you. Much better to show them that you will make a lot of money even if you don't get millions of users because your gross margins are so high that even relatively low sales will yield huge profits.

How Much Money do you Need?

Here is a well-known truth amongst people who have done several startups. If you have a really hot startup with rapid sales growth then you will get plenty of offers at a very low price.

But if are like most startups you currently don't have any sales and it will be at least a year or more before you get any, and even then they won't be large. In that case you really do need the money.

In that case it's likely that you won't get any offers at all, or only a few, at a very high equity price that will take away most of your equity. When you don't need the money, you will get plenty of offers and when you do really need it, maybe you won't get any.

You might want to believe otherwise. But the problem is that when exciting startups do get money, these are highly publicized events that newspapers and magazines love to talk about. But actually these events are quite unusual. The vast majority of startups that do need a lot of money rarely get funded, except for friends and family.

What this means in practice is that you have two ways to go. If you are one of the lucky few in an exciting and rapidly expanding startup, then you should take as much money as you can at the cheapest price of equity since even if you don't need it, you will have it in hand just in case. And if you are one of the large majority that are not in such a happy position you will be working with F&F and should keep your cash demands as low as possible to keep them interested. They might be prepared to lose some money, but they want to keep it to a minimum.

Generally you must realize that the ,more money you raise from investors no matter who they are, the higher the risk you run that eventually you will lose your position. You might think that as the founder you are immune to getting fired. But in the case you do get larger with more employees, one of more of might be able to replace you. If you have raised a lot of money and your investors get angry with you because you are not meeting your promises to them, they might try to find a way to replace you or diminish your responsibilities in such a way that you are forced to leave the company.

In other words, taking too much money could threaten your control. You might think that you can structure your capital in such a way that you maintain most of the voting power, much as Mark Zuckerberg has done in Facebook and as has also happened in numerous other successful and famous US startups, again a statistically unlikely event.

If you are not in this happy position, your company does not do well and you need more money from investors, their condition might be that you will only get the money if you either leave or take a less senior position in the company. So it is wise to seek less rather than more funding if you think there is no possibility that you might not be able to meet your promises to investors.

Other Types of Funding

Usually with a startup you will look for equity funding from F&F. It is almost never feasible that you can get a loan from a bank – your startup is far too risky for that possibility. But there is one other possibility, namely customer funding.

You might think that this is not feasible for a company that has no sales or almost no sales. However invariably a startup needs to find its first customer so that it uses the customer to test its products in the real world.

Often that first customer becomes a champion of the startup and its product. I have seen numerous startups that have actually landed their first customer and made use of them for funding.

In many if not most of these cases, the customer has not paid any money for the product since they are taking a risk in using it. But in many of these cases, although the customer might not be prepared to pay for the product, they are sometimes prepared to provide some funding for the company either in the form of equity or a loan.

Often this can lead to a valuable partnership since the client can help the startup to design and refine its product and make it better to use in the real world. Also the client can act as a reference for the product with other prospects which will help the startup get other sales by adding to its credibility. So client funding is not useful just for financing purposes, but also for improving the product and helping grow sales.

And How to Value the Company?

So how do you value your company for the purposes of this financing? Here is where your story becomes really important.

Believe it or not, if you have a really big story that most people might think unrealistically optimistic, then you will get a much higher valuation as long as your financials support the story.

In particular that means that the gross margin must be very high, if it is a tech company. If it is not, then your financials must be internally consistent. By that I mean that for example that the expense figures are consistent with sales figures; and cost of sales metrics must be consistent with the number of employees including their benefits such as health insurance. If this isn't the case, then a potential investor, possibly a professional, will find your overall story not credible.

In valuing your company there are 4 methods. The first is profitability and earnings. Using this approach you use a figure called price-to-earnings, the price of your stock compared to its earnings. However the vast majority of startups don't have earnings so this is really just a theoretical approach for most of them.

The second method is price-to-sales. This substitutes sales for earnings. Again most startups have either no sales or only small sales so this might not be very useful also.

A more common method is to use a gross margin approach. This compares your gross margin to competitors or somewhat similar companies and then values the company by projecting your future sales and comparing them to a competitor. This is a very rough approach since if you only have one customer with a high gross margin but are losing a loot of money it's difficult to make future sales figures credible.

The fourth approach is to use sales growth. Again it's difficult if you have only one customer (or even none). Obviously the higher the sales growth the higher the valuation. You get your valuation by comparing your sales growth to that of competitors.

As you can see all of these methods of valuation are very imperfect (as are all valuation methods). This is why a good story is so important. You will use your story to add support to your valuation by showing how it sets out the overall vision and the sales that derive from this vision. Ultimately valuation is about belief and the better the story, the higher the belief by potential investors, then the higher the valuation you will get.

Dr. E. Ted Prince, the Founder and CEO of the Perth Leadership Institute, located in Florida in the US has also been CEO of several other companies, both public and private. He is the author of 'The Three Financial Styles of Very Successful Leaders (McGraw-Hill, 2005) and numerous other publications in this area. He is a frequent speaker at industry conferences. He works with large corporations globally on leadership development programs and coaches senior executives and teams in the area of financial leadership. He has held the position of Visiting Professor at the University of Florida in the US in its Graduate Business School and also at the Shanghai University of Finance and Economics in China.