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When the VCs say "no"

13-17 minutes

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This post is about what to do between when the VCs say "no" to funding your startup, and when you either change their minds or find some other path.

I'm going to assume that you've done all the basics: developed a plan and a pitch, decided that venture financing is right for you and you are right for venture financing, lined up meetings with properly qualified VCs, and made your pitch.

And the answer has come back and it's "no".

One "no" doesn't mean anything -- the VC could just be having a bad day, or she had a bad experience with another company in your category, or she had a bad experience with another company with a similar name, or she had a bad experience with another founder who kind of looks like you, or her Mercedes SLR McLaren's engine could have blown up on the freeway that morning -- it could be anything. Go meet with more VCs.

If you meet with three VCs and they all say "no", it could just be a big coincidence. Go meet with more VCs.

If you meet with five, or six, or eight VCs and they all say no, it's not a coincidence.

There is something wrong with your plan.

Or, even if there isn't, there might as well be, because you're still not getting funded.

Meeting with more VCs after a bunch have said no is probably a waste of time. Instead, retool your plan -- which is what this post is about.

But **first, lay the groundwork to go back in later**.

It's an old -- and true -- cliche that VCs rarely actually say "no" -- more often they say "maybe", or "not right now", or "my partners aren't sure", or "that's interesting, let me think about it".

They do that because they don't want to invest in your company given the current facts, but they want to keep the door open in case the facts change.

And that's exactly what you want -- you want to be able to go back to them with a new set of facts, and change their minds, and get to "yes".

So be sure to take "no" gracefully -- politely ask them for feedback (which they probably won't give you, at least not completely honestly -- nobody likes calling someone else's baby ugly -- believe me, I've done it), thank them for their time, and ask if you can call them again if things change.

Trust me -- they'd much rather be saying "yes" than "no" -- they need all the good investments they can get.

Second, consider the environment.

Being told "no" by VCs in 1999 is a lot different than being told "no" in 2002.

If you were told "no" in 1999, I'm sure you're a wonderful person and you have huge potential and your mother loves you very much, but your plan really was seriously flawed.

If you were told "no" in 2002, you probably actually were the next Google, but most of the VCs were hiding under their desks and they just missed it.

In my opinion, we're now in a much more rational environment than either of those extremes -- a lot of good plans are being funded, along with some bad ones, but not all the bad ones.

I'll proceed under the assumption that we're in normal times. But if things get truly euphoric or truly funereal again, the rest of this post will probably not be very helpful -- in either case.

Third, retool your plan.

This is the hard part -- changing the facts of your plan and what you are trying to do, to make your company more fundable.

To describe the dimensions that you should consider as you contemplate retooling your plan, let me introduce the **onion theory of risk**.

If you're an investor, you look at the risk around an investment as if it's an onion. Just like you peel an onion and remove each layer in turn, risk in a startup investment comes in layers that get peeled away -- reduced -- one by one.

Your challenge as an entrepreneur trying to raise venture capital is to keep peeling layers of risk off of your particular onion until the VCs say "yes" -- until the risk in your startup is reduced to the point where investing in your startup doesn't look terrifying and merely looks risky.

What are the layers of risk for a high-tech startup?

It depends on the startup, but here are some of the common ones:

Founder risk -- does the startup have the right founding team? A common founding team might include a great technologist, plus someone who can run the company, at least to start. Is the technologist really all that? Is the business person capable of running the company? Is the business person missing from the team altogether? Is it a business person or business people with no technologist, and therefore virtually unfundable?

Market risk -- is there a market for the product (using the term product and service interchangeably)? Will anyone want it? Will they pay for it? How much will they pay? How do we know?

Competition risk -- are there too many other startups already doing this? Is this startup sufficiently differentiated from the other startups, and also differentiated from any large incumbents?

Timing risk -- is it too early? Is it too late?

Financing risk -- after we invest in this round, how many additional rounds of financing will be required for the company to become profitable, and what will the dollar total be? How certain are we about these estimates? How do we know?

Marketing risk -- will this startup be able to cut through the noise? How much will marketing cost? Do the economics of customer acquisition -- the cost to acquire a customer, and the revenue that customer will generate -- work?

Distribution risk -- does this startup need certain distribution partners to succeed? Will it be able to get them? How? (For example, this is a common problem with mobile startups that need deals with major mobile carriers to succeed.)

Technology risk -- can the product be built? Does it involve rocket science -- or an equivalent, like artificial intelligence or natural language processing? Are there fundamental breakthroughs that need to happen? If so, how certain are we that they will happen, or that this team will be able to make them?

Product risk -- even assuming the product can in theory be built, can this team build it?

Hiring risk -- what positions does the startup need to hire for in order to execute its plan? E.g. a startup planning to build a high-scale web service will need a VP of Operations -- will the founding team be able to hire a good one?

Location risk -- where is the startup located? Can it hire the right talent in that location? And will I as the VC need to drive more than 20 minutes in my Mercedes SLR McLaren to get there?

You know, when you stack up all these layers and look at the full onion, you realize it's amazing that *any* venture investments ever get made.

What you need to do is take a hard-headed look at each of these risks -- and any others that are specific to your startup and its category -- and put yourself in the VC's shoes: what could this startup do to minimize or eliminate enough of these risks to make the company fundable?

Then do those things.

This isn't very much fun, since it will probably involve making significant changes to your plan, but look on the bright side: it's excellent practice for when your company ultimately goes public and has to file an S1 registration statement with the SEC, in which you have to itemize in huge detail every conceivable risk and bad thing that could ever possibly happen to you, up to and including global warming.

Some ideas on reducing risk:

Founder risk -- the tough one. If you're the technologist on a founding team with a business person, you have to consider the possibility that the VCs don't think the business person is strong enough to be the founding CEO. Or vice versa, maybe they think the technologist isn't strong enough to build the product. You may have to swap out one or more founders, and/or add one or more founders.

I put this one right up front because it can be a huge issue and the odds of someone being honest with you about it in the specific are not that high.

Market risk -- you probably need to validate the market, at a practical level. Sometimes more detailed and analytical market research will solve the problem, but more often you actually need to go get some customers to demonstrate that the market exists. Preferably, paying customers. Or at least credible prospects who will talk to VCs to validate the market hypothesis.

Competition risk -- is your differentiation really sharp enough? Rethink this one from the ground up. Lots of startups do not have strong enough differentiation out of the gate, even after they get funded. If you don't have a really solid idea as to how you're dramatically different from or advantaged over known and unknown competitors, you might not want to start a company in the first place.

Two additional points on competition risk that founders routinely screw up in VC pitches:

Never, ever say that you have no competitors. That signals naivete. Great markets draw competitors, and so if you really have no competition, you must not be in a great market. Even if you really believe you have no competitors, create a competitive landscape slide with adjacent companies in related market segments and be ready to talk crisply about how you are like and unlike those adjacent companies.

And never, ever say your market projections indicate you're going to be hugely successful if you get only 2% of your (extremely large) market. That also signals naivete. If you're going after 2% of a large market, that means the presumably larger companies that are going to take the other 98% are going to kill you. You have to have a theory for how you're going to get a significantly higher market share than 2%. (I pick 2% because that's the cliche, but if you're a VC, you've probably heard someone use it.)

Timing risk -- the only thing to do here is to make more progress, and demonstrate that you're not too early or too late. Getting customers in the bag is the most valuable thing you can do on this one.

Financing risk -- rethink very carefully how much money you will need to raise after this round of financing, and try to change the plan in plausible ways to require less money. For example, only serve Cristal at your launch party, and not Remy Martin "Black Pearl" Louis XIII cognac.

Marketing risk -- first, make sure your differentiation is super-sharp, because without that, you probably won't be able to stand out from the noise.

Then, model out your customer acquisition economics in detail and make sure that you can show how you'll get more revenue from a customer than it will cost in sales and marketing expense to acquire that customer. This is a common problem for startups pursuing the small business market, for example.

If it turns out you need a lot of money in absolute terms for marketing, look for alternate approaches -- perhaps guerilla marketing, or some form of virality.

Distribution risk -- this is a very tough one -- if your plan has distribution risk, which is to say you need a key distribution partner to make it work, personally I'd recommend shelving the plan and doing something else. Otherwise, you may need to go get the distribution deal before you can raise money, which is almost impossible.

Technology risk -- there's only one way around this, which is to build the product, or at least get it to beta, and then raise money.

Product risk -- same answer -- build it.

Hiring risk -- the best way to address this is to figure out which position/positions the VCs are worried about, and add it/them to the founding team. This will mean additional dilution for you, but it's probably the only way to solve the problem.

Location risk -- this is the one you're really not going to like. If you're not in a major center of entrepreneurialism and you're having trouble raising money, you probably need to move. There's a reason why most films get made in Los Angeles, and there's a reason most venture-backed US tech startups happen in Silicon Valley and handful of other places -- that's where the money is. You can start a company wherever you want, but you may not be able to get it funded there.

You'll notice that a lot of what you may need to do is *kick the ball further down the road* -- make more progress against your plan before you raise venture capital.

This obviously raises the issue of how you're supposed to do that before you've raised money.

Try to raise angel money, or bootstrap off of initial customers or consulting contracts, or work on it after hours while keeping your current job, or quit your job and live off of credit cards for a while.

Lots of entrepreneurs have done these things and succeeded -- and of course, many have failed.

Nobody said this would be easy.

The most valuable thing you can do is actually build your product. When in doubt, focus on that.

The next most valuable thing you can do is get customers -- or, for a consumer Internet service, establish a pattern of page view growth.

The whole theory of venture capital is that VCs are investing in risk -- another term for venture capital is "risk capital" -- but the reality is that VCs will only take on so much risk, and the best thing you can do to optimize your chances of raising money is to take out risk.

Peel away at the onion.

Then, once you've done that, recraft the pitch around the new facts. Go do the pitches again. And repeat as necessary.

And to end on a happy note, remember that "yes" can turn into "no" at any point up until the cash hits your company's bank account.

So keep your options open all the way to the end.