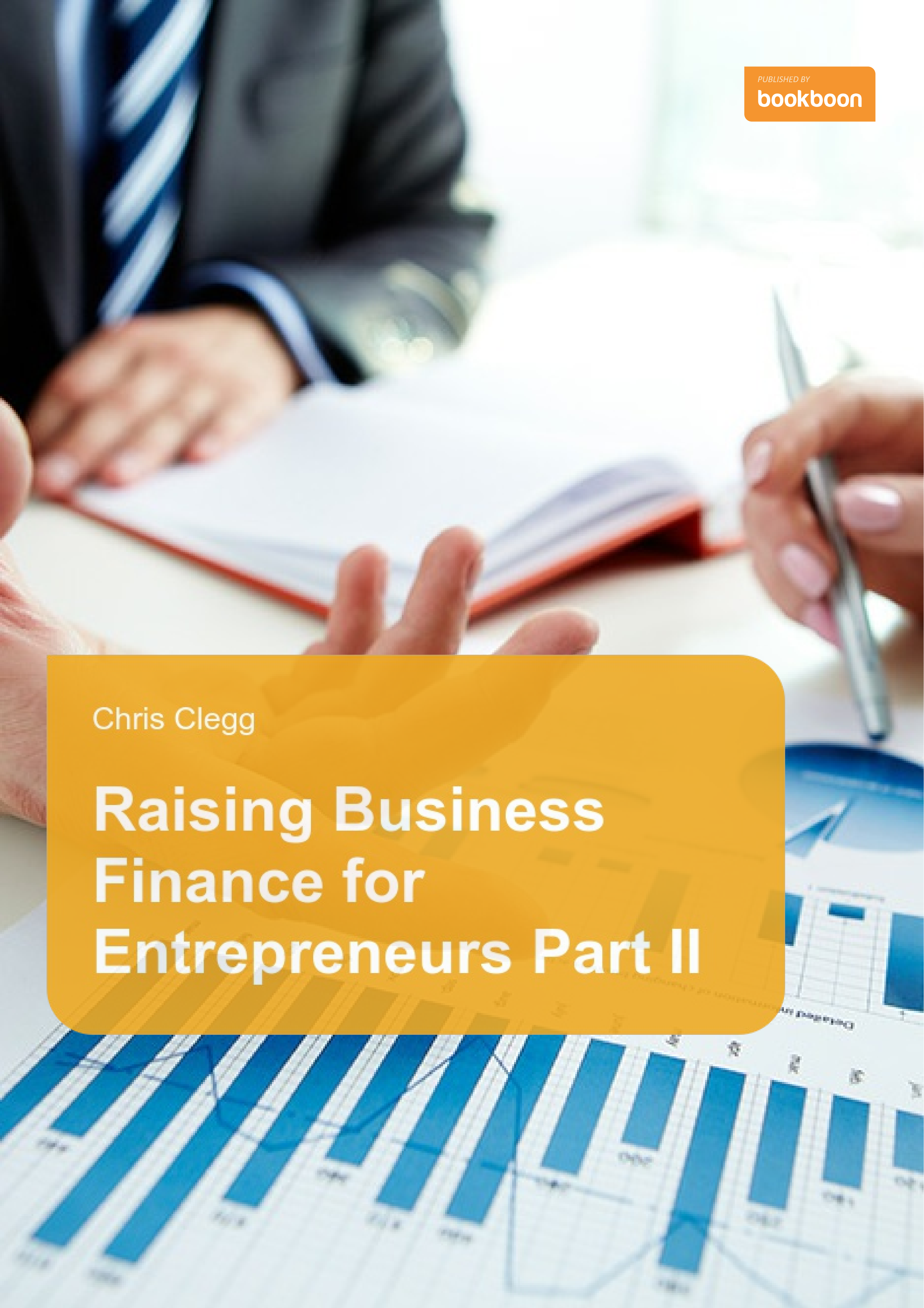

PUBLISHED BY bookboon

Chris Clegg

Raising Business Finance for Entrepreneurs Part II

CHRIS CLEGG

RAISING BUSINESS FINANCE FOR ENTREPRENEURS PART II

Raising Business Finance for Entrepreneurs Part II
1st edition

ISBN 978-87-403-0757-3

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7 ASSESSING REWARD

In which we look at various ways early stage valuations can be derived, mostly from the perspective of investors

7.1 REWARD

With the risks understood and quantified, the investor needs to make a similar judgement about the rewards on offer. He obviously will not invest if the rewards do not outweigh the risks, but he also has to determine how the risk-reward profile fits in with his desired portfolio. Presumably he will have a fairly good idea of what to expect, or he would not have got this far down the process, but he now needs to do some detailed analysis.

There will doubtless be many potential areas of personal reward for the investor in terms of interest and lifestyle, continuing to do something of value for the community, and considerable satisfaction in success. Inevitably, of course, of over-riding importance are the financial rewards that can accrue. The investor's ultimate financial reward is the cash he ends up with after making a successful sale of his shares at an exit. What and when this will be is of course unknowable to start with, but estimates have to be made.

The high degree of uncertainty inherent in seed and early-stage investments has a direct effect on valuations achievable in the market place: they are very difficult.

This has very important implications for both investor and entrepreneur. Ultimately, the value put on a business will be a range, from the lower one of the investor to the higher one of the entrepreneur. Experience suggests that there is often a factor of up to ten between the two, with the eventual agreed figure (if one can be arrived at!) being very much closer to what the investor wanted than to what the entrepreneur wanted.

Essentially, company valuation is based upon what its potential earnings are worth today to a rational investor. So to arrive at a reasonable and realistic valuation the profits, cash flows and net assets must be projected to that point in the future when the sale of the company is proposed; the amount a potential purchaser will pay over and above the baseline – the multiple – has to be deduced, so a sale value can be arrived at; and this sale value has to be converted into today's money terms so it can be compared with the money invested.

In other words, for early stage opportunities where there are no business 'valuation drivers', it's all pretty much a combination of several educated guesses multiplied and divided together. But that's what it is, so we have to have a go. We will look at how this can most fruitfully be achieved after examining some less rigorous methods.

In addition, of course the investor's reward can only arise from selling his percentage shareholding in the company. As yet, this has not been negotiated. The projected rewards can also be used 'backwards' to decide what shareholding the investor needs in order to make the deal doable from his point of view, and how the investment is split between shares and debt will also need to be factored in.

7.2 CLASSIC BUSINESS ANGEL METHODS

Principals most commonly persuade themselves that their opportunity is unique and 'once-in-a-lifetime'. It possibly is, for them. But for the investor it's just another business opportunity. It may be an exceptionally good one, usually it is not. The investor's decision whether or not to invest, and on what terms, will depend on what's in it for him: financially first, plus others.

How often does one hear that an entrepreneur needs, say, £500,000 for his business and he is 'prepared to release' 20% of the shares in exchange? Does that value his business at £2,500,000? Well, no.

The most common way an investor works out if a deal is acceptable is to calculate what reward he needs in order to compensate him for the risk he judges he is taking with his money. He needs to be confident that the promised rewards at worst exceed his investment, net of any tax he might be saving.

Let us take an example, call it Get Rich Ltd, where he is being asked to invest £100,000 net. Having assessed the risks, the investor's judgement is that he has a one-in-ten chance of getting his reward. He therefore needs to see a return that exceeds ten-to-one, let's say he wants fifteen-to-one. That means that on today's terms he wants to get £1,500,000 back for his investment. So far so good. Let's assume that he works out that today's value of a potential sale for the company is £10,000,000, so he has to have a minimum of 15% of that £10,000,000. He will therefore be prepared to accept 15% of the shares for his £100,000 investment, and if that is acceptable to the entrepreneur then a deal is possible.

But what if the calculated return in today's terms is only £6,000,000? The investor will obviously need 25% of the shares in order to feel comfortable enough to invest. At a £5,000,000 return, the shareholding must be 30.0%, and so on. The deal may happen, or it may not, depending on the entrepreneur's perception of the value of his 'baby'. And this is very often a sticking point.

In circumstances where the principal doesn't or can't see sense, we have always advised him not to raise money for 20% but to sell their whole business now: all 100%. If he wishes to sell only 20% of he business for £500,000, we suggest that he will make much more money much more quickly by selling the whole thing for £2,500,000. Very few fail to see the absurdity of this proposition, and agree that their valuation is faulty; to those few who insisted, we wished good luck.

Now if the business plan needs £500,000, that is what it needs; but how much cash the business needs is completely unrelated to its value. The value depends on what the business is worth, not how much cash it needs. The percentage that the principal wishes to retain also has nothing to do with valuation (or even control of the business, as we shall see later). If, say, after negotiation the business values at £200,000 and the principal will release only 20% of the shares, then his 80% shareholding cost the £200,000 value of the business, hence the post investment value of the business is calculated to be £250,000. The cost of 20% of that is £50,000, so the shareholding of the investor will cost just £50,000. Any additional cash needed by the business will come in as some form of debt. So in this example the £500,000 will be divided into £50,000 shares for 20% of the business, and a £450,000 loan on terms to be negotiated.

From their different viewpoints, the value to each of the deal can be very different and any agreement between investor and principal is often just the result of 'arm wrestling', who blinks first. It often means no more than a more-or-less arbitrary figure reached through negotiation between the investor and the principal where the pain barrier of both is equal, and has little to do with any inherent business values. To get a good value, don't blink first! And it's usually the principal who has to blink as he has little choice, whereas the investor has dozens of choices of where to invest, including nowhere.

There are, however, some classic ways that have been devised. These of their nature are rough and ready, but combining some or all should give a better feel for the ball park.

7.2.1 CLASSIC BUSINESS ANGEL METHODS: DAVID BERKUS' BUSINESS STAGE

As we said earlier, David Berkus is the creator of a simple method by which values are ascribed to early stage businesses based upon the concept, level of development, competence of its management team, experience of its board of directors, and maturity of its revenues. The more advanced each of his parameters is, the more inherent value he ascribes to it. Quite logically, a business whose only merit is that its principal has belief is worth considerably less than one where there are profitable, recurrent revenues and a strong Board and management, and which badly needs cash to conquer new markets.

This method is sound in principle and has much going for it except for one thing: who is coming up with the imputed values? Those that Mr Berkus was happy with in late 20th century California – before the 'dot com' boom and bust – are now simply irrelevant, so anyone using the system now would have to use a lot of trial and error. And, in any event, just because an investor deems a business to have an imputed value, it may not be agreeable to the principal and leads us straight back to arm wrestling.

7.2.2 CLASSIC BUSINESS ANGEL METHODS: COMPENSATED ADVISER/ VIRTUAL CEO

This is especially useful if the cash is mostly needed to buy people and expertise, and less so otherwise. It is in some ways comparable to SME valuation where the profits taken by the directors (and hence not shown on the books) are added back before applying relevant multiples. Of course, in Business Angel investment there are no profits, hidden or otherwise, to add back so the investor's time as Mentor is given a value. A cash value is put on the investor's time input, the company is given a value based on that and the shareholding worked out. Effectively the investor is buying his stake in the company in return for time and expertise.

There are circumstances where this works well, but it is pedantic and starting off on this footing doesn't auger well. The principal often feels himself to be under duress and accepts such terms reluctantly; as a valuation tool it tends to multiply subjectivity by itself.

7.2.3 CLASSIC BUSINESS ANGEL METHODS: LUCIUS CARY'S RULE OF THIRDS

This 'rule of thumb' used traditionally in Business Angel investing was devised by Lucius Cary, founder of Venture Capital Report. Where there is no realistic business valuation possible, why not simply give one third to the investor, one third to the principal and one third to the management, who in practice are often same as the principal? After all, any business is wholly dependant on all three, so each is in is own way indispensable. As a way of dividing up the company, it's transparent, as fair as possible, very simple, and avoids all argument. The principal, however, may disagree.

7.2.4 CLASSIC BUSINESS ANGEL METHODS: PUT IT OFF 'TIL LATER

There are two ways to avoid early stage valuations completely. Both are neat and avoid arguing over very early stage values by agreeing that the value put on the early stage will be determined later. Both have the small disadvantage of potentially tricky paperwork, which inevitably means increased costs, and the much larger disadvantage of leaving the risk-taking early investors at the mercy of second round vultures who can torpedo the terms of the agreement. But, you might think, there's nothing new in that.

7.2.4.1 Classic Business Angel Methods: Put it off 'til later Top Down

In the first round investment, debt finance is used. The terms of the debt are such that on any subsequent funding round, however the next round is invested (ordinary shares, preference shares, debt notes, whatever) the first round debt is convertible into exactly the same vehicle as the later round but at a large discount to the second round terms to reflect the extra risks already taken. This is obviously very easy for both parties to agree to initially, but far more difficult to enforce later.

7.2.4.2 Classic Business Angel Methods: Put it off 'til later Bottom Up

Again, first round funding is via debt finance, and again it is convertible on any second round. But this time instead of being linked to the terms of the subsequent investor, it provides the first round investor with a specified, and theoretically guaranteed, return. This potentially gives the first round investor the comfort of knowing that he will make the profits he seeks, but again it depends entirely on the second round funder agreeing with him. And trying to enforce such agreements can even prompt second round funders to lose what interest they have…

7.2.5 CLASSIC BUSINESS ANGEL METHODS: GREED RATIO OR ENVY RATIO

The 'greed ratio' or 'envy ratio' is a tool most frequently found in VC assisted MBOs. The management are given preferential terms for the purchase of their shares, usually as a motivational tool to help ensure that the VC gets the returns it requires. It is worked out as the ratio between the price per share that the management, or in our case the entrepreneur, is paying and the price per share that the VC, or in our case the investor, is paying. The principal's input has to be actual money, 'sweat equity' does not count. It doesn't directly give a value, but can be used to derive something sensible by working backwards from what money the Principal has already committed. It is best thought of as a sense check.

$$\text{Greed ratio} = \frac{\text{£ per share paid by investor}}{\text{£ per share paid by principal}}$$

Perhaps this is most easily seen in an example. Let's say that the principal has spent £80,000 in getting his project to the point where he is looking for an investor, and he is asking for £200,000 new investment for 20% of the business. Here, the principal has spent £80,000 on 80% of the shares, so has paid £1,000 per %. The investor is being asked to pay £200,000 for 20% of the shares, which is £10,000 per %. Therefore the 'greed ratio' is £10,000 divided by £1,000 or ten to one.

The usual range maximum acceptable range is between five to one and eight to one. It simply will not happen in a Business Angel context that it is less than five to one, and if it is over ten to one it is easy to understand where the term 'greed' comes from. As a back of the envelope check, the greed ratio is a useful tool, but determining the 'price' paid by Principals can be tricky. For instance, investors sometimes think of insisting that the principal capitalises any existing loans he might have, but that's not very tax efficient. And what about retained profits, if there are any? What about family money? What about Grants or Awards and so forth that might have contributed to the IPR? Even agreeing what the Principal has already contributed can be contentious.

7.3 TRADITIONAL VALUATION METHODS

There are many factors that traditionally come into play to influence the value of a business, and business valuation is a relatively formal procedure for established companies. Although formal valuation methods are applied by some Business Angel investors, it is certainly not a rule and they generally have very limited application in the Business Angel world, but nevertheless it is still essential to have a handle on their value implications. And, inevitably, no allowances for the investor's tax status can be made in these calculations.

7.3.1 TRADITIONAL VALUATION METHODS: NET PRESENT VALUE

This is essentially a best estimate of today's cash value of the investor's future reward, and is known as the Net Present Value (NPV). To work this out takes a few steps and requires several working assumptions. It is obviously easy if the company is established and giving regular and reliable dividends, but far less so when variables have to be factored in, and especially so when the variables include a big chunk of hope about growth before the expectation of future earnings.

Even with established, steady businesses the calculations require assumptions about what expectations can realistically be made: will the business continue to grow at a steady rate, and what is that rate? How much of a multiple of tomorrow's earnings will a future purchaser be prepared to pay in order to buy the then business? What will be the rate of inflation over the next several years, in order to bring future values back to today's?

More accurately, the measure of 'earnings' used is called 'earnings before interest tax depreciation and amortisation', or EBITDA. In practice, the chance of coming across a Business Angel investment that has anything beyond the E in EBITDA is very slender, but it's important to be aware.

In principle, the first bit's easy: from the plan, take the projected earnings for each year and apply a discount to get back to today's value. For early stage investments we target a minimum Internal Rate of Return (IRR) of 30%. Why 30%? The answer is straightforward: it's all about building a profitable portfolio.

Over 5 years, an investment returning 30% pa will grow about four-fold. Thus one business exiting successfully after five years will pay for three other investments that fail: a ratio of one in four. As we saw in the section on Portfolio Building, statistics show that there are about three successes for every twelve investments, also a ratio of one in four. We also saw that one investment in twelve is likely to be a real 'winner'. Therefore as a good generalisation, if we use 30% as our target return, we end up with a portfolio that stands a very fair chance of returning a decent overall profit. The higher the IRR used in the calculation, the better; and also the less the chance of finding enough suitable opportunities.

If, then, we wish to calculate today's value of the business in five years' time, we need the sum of the values of the projected earnings over those five years discounted at 30% per year; if the desired value is that in six years' time, then the sum is of the discounted earnings over six years…and so forth.

Let's take another example, this time Brilliant Idea Ltd. If the earnings are £0, £0.2m, £0.8m, £1.6m and £4.8m then over the next five years the sum is £0m discounted by 30%, plus £0.2m discounted by 30% pa over two years, plus £0.8m discounted by 30% pa over three years, plus £1.6m discounted by 30% pa over four years, plus £4.8m discounted by 30% pa over five years. This works out at £1,563,296, so the NPV of this business's five year earnings is near enough £1.5m

As can clearly be seen in this example, NPV is greatly influenced by the chosen discount rate. Selecting the appropriate discount rate, the 'required rate of return' is critical. The 'required rate of return' is the minimum acceptable return on an investment and should reflect the riskiness of the investment. It must also take into account any proposed financing mix. It is common in Private Investment and VC circles to use discounts of 30% pa to 75% pa.

Don't forget that the Net Present Value gives us the value of the business, but you are only allowed to sell your own shares at an exit. To arrive at your own reward figure, the NPV has to be that of your percentage holding so you compare the NPV of your future earnings with the cost of your shares.

Another way to use NPV is 'backwards': if you were to have an investment in the company, what percentage shareholding would you need to get a realistic rate of return, as we saw above with Get Rich Ltd? Is that possible, given the Principal's opening position? Maybe think about using debt as well as shares, and we'll have a look at that later.

So far so good, but in a fast growing business seeking an exit, it's no good just valuing the first five years' income. There's going to be much more after that. We turn to the next problem.

7.3.2 TRADITIONAL VALUATION METHODS: MULTIPLES

Calculating the NPV of a business is often very useful, but purchasers don't pay exactly pound for pound what a business earns, even discounted to today's values. They pay a multiple of that, depending upon what, in their view, is the reliability of the earnings. Then they add more for the hope value that a business has currently unrealised potential. Or at least, that is what the vendor hopes; all too often the purchaser tries to discount for risk and future contraction. In any event, multiples of earnings have to be factored in to give a composite figure.

First, decide what would be a sensible multiple based upon the business's maturity and stability: clearly this will change as time passes, but as it is all conjecture anyway don't push your or the business's luck by going too far forward.

These are example multiple guidelines for SMEs:

- three to five times profits
  An extremely well-established and steady business with a rock-solid market position, whose continued earnings will not be dependent upon the incumbent management team.

- two to four times profits
  An established business with a good market position, with some competitive pressures and some swings in earnings, requiring continual management attention.

- one-and-a-half to three times profits
  An established business with no significant competitive advantages, stiff competition, few hard assets, and heavy dependency upon management's skills for success.

- up to one times profits
  A small personal service business where the new owner will be the only, or one of the only, professional service providers.

In the example Brilliant Idea Ltd, let's say the multiple of earnings achieved by comparable businesses at sale is 6. The NPV = value of year five earnings × multiple × discount. Year five earnings is £4,800,000, the multiple is 6, and the discount is 30% per year for five years, which is 0.168. This comes to £28,800,000 × 0.168, so the NPV of the hoped for sale value in five years time is £4,840,416 or about £4.8m. Then this has to be discounted for the investor's shareholding, and let's say he holds 40% of the shares, which gives the investor £4.8m × 40% = £1.92m cash at today's values.

But we're not dealing with 'For Sale' businesses, we are dealing with start ups. Future multiples will depend on what some future analyst's assessment of what the future business is projected to earn. Typically, even once a comparable multiple has been identified, various discounts for private companies, minority shareholdings, and small size will be applied, and an allowance also discounted for the time to produce results. It could with some justification be claimed that a finger in the air would be more accurate.

7.3.2.1 The BDO Private Company Price Index

http://www.bdo.co.uk

The BDO PCPI is a quarterly index that tracks the discount between how public and private companies are being valued. Each edition looks at the state of the market for private company deals, focuses on trends specific to a given sector and explores topical market issues. The index is recognised as the most authoritative source on private company values by practitioners including the Inland Revenue and leading accountancy firms. The Q1 2013 PCPI indicates that, on average, private companies were being sold for 8.5 times their enterprise value to trade buyers, and 7.7 times to private equity.

The PCPI is calculated from FTSE data and from publicly available financial information on private deals. Included deals have had a mean deal size of some £15m and a median deal size of some £5m. Therefore, if a company is smaller than this, then a further discount should be applied.

Traditionally, private companies are generally owner-managed and reported or disclosed profits tend to be suppressed by various expenses that may be non-recurring under a new owner (which is a euphemism for squirrelled away in pay and benefits). This will have been factored into the price the purchaser paid, but may not be reflected in the profits declared to the public. The effect of this is that the price-earnings ratio paid as calculated from the publicly available information may be over stated.

The Private Company discount enables valuation techniques to be used which are only relevant to public companies, and then apply them to private companies in the same sector. The difficulty over the last several years can easily be seen, however. Giant Private Equity Houses have prowled the markets aggressively acquiring companies where they think they can see an imbalance between quoted price and potential value. This has had the effect of significantly narrowing the 'PCPI' gap, and somewhat devalued its usefulness.

It should also be noted that the PCPI is an average measure and guide, not an absolute measure of value, as there are many other factors that can have an impact on value. But at least it exists, and as general guidance it is certainly useful.

7.3.2.2 Traditional Valuation Methods: Comparables

For those who are prepared to put in a lot of groundwork, it is also possible to get an idea of what multiple to apply by looking at comparable quoted companies. A common feature should be identified in order to try to get a sufficiently similar sector, and then it is easy to look up the price-earnings (p/e) ratio and, using the PCPI, pro-rate it for the company in question.

The real trouble here is that finding a good fit can be very subjective, because with most small, ground-breaking businesses there isn't really anything in the quoted markets to compare it with. So it can be almost impossible to find a good match, and back breaking simply doing the research.

And even if you do strike lucky, any small company/non-quoted/early stage discount to be applied will by definition be a guess, which rather defeats the primary purpose of objectivity.

Finally, it is theoretically possible to look at recent acquisitions or funding deals of Private businesses, but short of paying fees to business analysts, or trawling through millions of pieces of old data in Companies House, where do you find the relevant information? The Cambridge based Library House used to publish much useful data and statistics, but at the time of writing their place has not been filled since they disappeared.

7.3.3 TRADITIONAL VALUATION METHODS: NET PRESENT VALUE BASED ON CASH FLOWS

When Venture Capital Houses are looking at second round funding, they can also use a modification of NPV using cash flows rather than earnings. The calculations are directly comparable. And if VCs use it, in theory it should be useful for start ups: to get the return you need, you have to have the percentage shareholding you need and no arguments.

But of course this suffers from the same problems as every other method for valuing start ups: whose projections do you use?

7.3.4 TRADITIONAL VALUATION METHODS: NET ASSETS

Fairly obviously, paying for real assets is fair enough. The price will be haggled over and the value of the assets questioned, but real assets are real. Which is fine if there are any, which is rare enough in a start up business, but what about the Intellectual Property?

Intellectual Property is often of value even prior to exploitation, and holds the promise of much more. But precisely how much value should be put on something that has yet to make any sales? If it is pre-revenue, by definition there's no demonstrated demand for the product. There are specialist Intellectual Property valuation companies around, but they tend to be expensive and they too struggle with pre-revenue businesses and disruptive market opportunities.

They do, however, provide the opportunity for either side in the negotiation to 'threaten' the other: "If you don't accept my valuation of the IP you are welcome to pay for a formal valuation to be done…."

Other considerations when applying formal asset values to Business Angel funding are that the opening Balance Sheet, IP aside, is very likely to be zero or negative. To balance this, the entrepreneur might have priced in his Sweat Equity. While this can be highly emotional, it is of zero financial value.

7.4 RISK-REWARD

The NPV is often used by entrepreneurs on their own or with a professional's advice as a justification for a 'formal' valuation. As we have shown, there are four major problems with this method when applied to pre-revenue, high growth businesses. What are the earnings going to be, and how long will they last? What will someone pay at some point in the future to get the earnings for themselves? How does that value relate to today's money? And after all that, what is the probability that all these above assumptions are nearly right?

Sometimes entrepreneurs get quite hung up over their valuation, ignoring completely the simple fact that without any money to fuel the business there will be nothing to project. As a suggestion to show them how important the cash is, ask them to try doing a projection for growth without the cash investment, and compare the two valuations.

As a check of investibility and common sense, the NPV calculation helps you decide if you are going to cover your risks with the potential reward. Be comfortable that it's imprecise, but do get a feel for using it as a guide.

From the plan, decide what you believe is a sensible projected future profit figure and multiply it by a sensible multiple; bring it back to today's values by discounting it at your required rate of return. At this point, you should make allowance for your tax position to arrive at your net amount to be invested. Now you can work out your share of the rewards through your percentage shareholding, or work out your required percentage shareholding from the reward you need to cover your risk.

So now you know what your percentage of the business could be worth in today's terms. How much cash, net of any tax discount, are they asking from you to buy this shareholding? How many times greater than your net cash input is the potential output: what Reward Ratio do you get? Have you decided you might be better off keeping your cash in the bank instead? A three to one reward might be a disaster, or could be excellent value, depending on how you rate the risks involved.

Once again, this is not intended to give specious rigour to an extremely subjective process: it is a way of thinking, a process to give you a simple handle. If you don't like your answer, change it! If you don't like the priorities we are suggesting to make up the 'risk' factors, change them so they do suit your preferences. It's just a tool to help, not to get hung up over.

Keep the value you have just calculated, it is the 'Reward' bit of 'Risk-Reward', and the final piece of the jigsaw.

The 'Risk Reward Ratio' is found by multiplying
Reward 'R' by Risk '1/r' = R/r
If this is greater than 1, the deal is worth looking at. Otherwise, keep your cash under the blanket, or at least review the terms of the deal.

But the figures will almost certainly need adjusting as this is a very tentative calculation; we first have to factor in other considerations and Uncertainties.

7.4.1 VALUATION RANGES USING UNCERTAINTY

By incorporating the concept of Uncertainty, the problem of agreeing a Valuation of a business can in fact be addressed in a relatively straightforward way. Using Uncertainty allows a way through this that is fair to both Business Angel and entrepreneur.

Most important first of all is a thorough testing of the business plan with the principals to understand the assumptions they have used and the uncertainties inherent in the assumptions, and the likelihood, value and timing of an exit.

We have previously identified sixteen independent variable assumptions, of which Debtor Days is one, that contribute to a Business Model each of which is 'Uncertain'. These assumptions are important factors in the projections that create Business values. The information is critical in understanding what the Principals are really doing when they put a 'value' on their business: they are, after all, quite justifiably projecting their own subjective intentions. But the variations from these projections as modified by both entrepreneur's and investor's doubts are equally valid.

As we have already pointed out, the Principals of a worthwhile business are inevitably going to be competent experienced managers who have a solid foundation for their business forecasts, and will probably argue that they are being 'cautiously optimistic' with 'realistic expectations' of major profit.

The objective in quantifying uncertainty is not to rubbish the entrepreneur's forecasts, because they are actually perfectly valid. It is to admit that they are not cast in stone, and will be subject to the variations which we call Uncertainty. Looking at their assumptions you decide what realistically, in your opinion and in theirs, could go wrong. You then do a series of re-projections using the range of variation in the assumptions, and using exactly the same methods as the entrepreneurs own calculations arrive at a new range of projected values. Ideally, the calculations with the uncertain variables included should be done tens of thousands of times, incorporating random variations in the agreed ranges of all the variables using a spreadsheet. This classic approach to analysing variation mathematically is known as Monte Carlo simulation.

The projections arising from these calculations will no longer be single lines, but ranges. They will be tight ranges for assumptions that are well managed and do not vary much, and very wide ranges for very uncertain assumptions. It is common for most projections to include negative values, meaning that the business has gone bust. And these fresh projected ranges are objectively just as valid as their unamended projections, and so a very valuable tool to be able to use.

Imagine the following scenario: the Principals need £250,000 and have offered 25% of the shares, valuing their business at £750,000 now and £1,000,000 post investment. With the management's direct input, all the uncertainties in the business assumptions have been identified and quantified.

Wouldn't you like to be able to say: "Well, I know you've valued your current business at £750,000 and it is a fair value, based upon the assumptions you have made. But I'm uncomfortable with it for several reasons – we have discussed the Uncertainties inherent in your assumptions, and there is a 95% probability that the range of valuations that is fair is £200,000 +/- £600,000, that is anywhere between minus £400,000 and plus £800,000. So your value of £750,000 is in there, but very toppy.

"Further, with your help we have made reasoned assessments of the riskiness of the proposal and firmly believe that to balance the risk of failure, I will need to have 40% of the business at a valuation of £200,000. This means that the post investment valuation is £333,000 and I will put in £133,000 in shares, and will lend you the extra £117,000. This gives you the £250,000 that you need and me the potential return I need to justify investing at all, while keeping you as motivated as is reasonably possible".

Remember that if both you and the business qualify for tax advantages in investment, you have to invest in ordinary risk shares, debt does not qualify. This obviously complicates the calculations, but not such that the approach should be ignored.

7.5 SUMMARY

Valuation is more of an art than a science, and identifies only a moment in the time line of a business. Each business is unique and different methods will apply, so do not just use one method. Compare each derived value with the others to get an overall feel. And don't forget that fundamentally you are taking a calculated risk in the very early stages by buying into an opportunity for creating wealth.

Once you and the principals have met, and you have made personal evaluations of all the Risk factors and Uncertainties, you have a simple way of deriving a basis for agreeing a deal, if it is at all doable. You can derive all the necessary value information and ranges to see if there is any common ground, and the model provides an 'independent' arbiter to negotiate from. The underlying principle is the Net Present Value (NPV) and what you have to pay for your share of it. This gives you your potential Reward. It offsets this by balancing it with your assessed Risk:

Risk-Reward Ratio = Reward 'R' × Risk '1/r = R/r: are you likely to make enough profit if it succeeds? Set a target return of at least 3:2 for investibility, but also look at the section Risk Management: Applying Modern Portfolio Theory for more background.

How much are you being asked to pay for a promise of what reward?

You can increase your reward by increasing shareholding and/or increase debt or other less risk investment vehicles as a proportion of the money you are investing. Make sure you also allow for the tax discount for risk shares, or lack of it for anything else, in your calculations.

8 GETTING FUNDED

In which we discuss how an entrepreneur can best approach investors with a view to getting funded

8.1 WHAT A BUSINESS PLAN IS FOR

There are four main reasons for writing a superb Business Plan.

Perhaps not so obviously, if a Plan is superb then it must by definition be describing a superb business opportunity. This is clearly very good news for everybody involved, because it is going to make a lot of money for everyone. Which is very nice; the whole point, really!

Secondly, a superb Business Plan is a reflection on the author. It shouts out loud in technicolour (to mix metaphors) that the author is someone highly capable, who knows his business inside out and back to front. Any investor reading a superb Business Plan is going to want to back the person who can produce such a compelling business, such a superb opportunity.

Thirdly, a superb Business Plan adds a great deal of value to the entrepreneur's proposition. No longer is he an applicant seeking someone – anyone – to back him, he is dictating the terms, inviting investors to make offers. Superb plans can even prompt competition between investors to be allowed to invest. The entrepreneur can demand a 'beauty parade' of potential investors, taking his pick of those who offer the most and demand the least in return.

And last but by no means least if you are serious about raising funds, your plan simply has to be superb for if it is not you will almost certainly fail. No ifs or buts, no excuses.

We have never seen a superb Business Plan fail to get investment on advantageous terms, but it has to be admitted that we haven't seen too many superb Business Plans. But we have seen maybe thousands of plans, some good, mostly dire, and roughly one percent actually manage to get any funding at all. So the effort of writing a superb Plan, of making your business into a superb one, has to be worth trying.

But, inevitably, there is a downside: first you have to write your Plan. And writing a superb Plan is not easy, it takes a lot of effort and research, and maybe taking some difficult decisions about your team. But it really is worth it.

Of course you may not be able to write a superb Plan: lots of things might prevent you. Often an entrepreneur is still holding down a full time job and working on his own business in what spare time he can find, and producing a superb Plan is simply beyond his resources. Whatever, make the very best case that it is possible to make. The better you make your plan, the better you research, manage and present your case, the more likely an investor is to want to back you and the higher is the value that you add to yourself and your proposition, so the less you will have to give away. So in order to give yourself the best chance of succeeding, leave nothing to chance and ensure you cover every angle.

The investor's first inkling that you exist usually comes with the first time he picks up your Business Plan. His first impressions could make or break your proposition, so you have no choice but to make them as good as you possibly can or live with the consequences.

You must be prepared to lose a share in your business, possibly a bigger share than you want or thought likely. Fifty percent of something is far bigger than one hundred percent of nothing. And if necessary you must be ready to share your business with those who are not investors but without whose input and skills you have no business.

8.2 WHAT A BUSINESS PLAN IS

This is about how and why you need to put into your Business Plan what you do.

Your business sells widgets. Your Business Plan sells investment in your business, not widgets. That is even worth repeating: your Business Plan is not to sell widgets.

Your plan is specifically to help you sell a share of your business to an investor at a meeting: widgets are just the way your business makes profits. And the first step in the process is to persuade the investor that he simply has to meet you. It's not what you sell, it's how you make money, why you make money, when you make money, and how much money you make by selling it. Your Business Plan is a sales document that sells you, it advertises you. In our context, it is aiming specifically to raise money from someone you have never met who has the money you want, and you need to meet him to explain why. That is what your Plan is.

8.3 HOW A BUSINESS PLAN IS READ

Most Business Angel investors are professionals, or at least they behave professionally when it comes to investing. Typically, each Angel might see up to ten or fifteen new Business Plans every week. Some will see many more. Please note that we said 'see', not 'read', and there is of course a major difference. Reading a plan properly will take upwards of a couple of hours, while many investors will spend only two or three minutes on each plan. Does it appeal? Does it make him want to read further? If not, it won't be read properly.

So it's not worth even wasting paper and postage unless you take writing your plan seriously and make a serious effort to get the investor to read it.

The reader will first of all try to understand what is in it for him. Does it excite? If so, he'll want to see if he thinks it is deliverable: can he visualise who wrote the plan. Was it the principal, or an adviser? If the latter, who owns the ideas? Was it written as a strategy for the writer to give him a road map, or is it little more than a wish list? Are the principals knowledgeable or do they come across as 'winging it'? And which audience was it written for: a bank, or management peers, or was it targeted at an investor?

Once it is read properly, and if you are still on his radar, it might join a pile of other plans that the investor has read and thinks interesting. If so, what will make your plan stand out so that when he revisits his 'interesting' pile he comes back to your plan? It must be memorable, both in content and in presentation. That need not mean expensive, simply visually memorable, as otherwise it could get overlooked. The investor may make only one or two investments each year so you have to make your plan compelling and memorable, from the first word on the front page onward. Don't give the reader any excuse to put it down.

If you think that this is a bit over the top, consider that you are asking him to back your judgement with lots of money for several years, and think again. His first impression of your ability is your document, so make it a good one.

8.4 WHAT KIND OF MONEY

It might seem as if 'money is money is money': that there is only one kind, and you get to spend it.

But for those people who have enough money to invest, either of their own or on behalf of others, it can be a very different story. They often have very specific requirements as to what happens to their money, what conditions are attached and what they expect in return.

And if an entrepreneur doesn't appreciate the differences, he is unlikely to succeed in persuading someone with money to part with it. It is critical that when writing a Business Plan you understand the nature of money. You need to have a very clear understanding of how much money you need, why you need it, what you will use it for, how long you need it for, what is the risk profile, what returns are you offering, and what you have to offer in return.

What do you need the money for: short term survival while customers pay you, or to cover quarterly VAT; longer term finance of capital equipment or plant; investment in people to make something happen which is currently under-resourced…or what? Deciding correctly what 'kind' of money you need is essential because approaching the wrong type of funder is embarrassing, and certainly a waste of everybody's time.

Any investor will want to reduce the downside of his perceived risk as far as possible, so it is essential that every entrepreneur fully understands where the investor is coming from. For example, acting as a manager for an institution that has money to lend or invest has its own problems and issues, not all of which relate to the decision whether or not to back you. It is very different having your own money. But trying to deal with an independently wealthy investor, answerable to no-one, brings its own set of problems.

8.5 KNOW YOUR TARGET

If you have read the book this far, you will have a good appreciation of the approach to investing that we advocate for Business Angels. If you have just jumped straight into this section, we recommend reading the previous sections to understand the background.

All interested investors will say they offer expertise, experience, contacts and hope, and some of them will be right. We have previously seen that investors can assist and add value through providing capital, introducing other funders, introducing and selling to key customers and strategic partners, advising on strategy and exit, attracting or introducing new talent, mentoring, acting as a sounding board for industry, function and experience, and raising the business' status and profile by adding presence credibility and personal reputation.

You will have to decide if the things they promise to bring with them are both deliverable and things that you actually need, and if the things they want from you in return are worth it. Which means you will have to know what you have to offer in return that is going to match with what they are likely to want. What security can you give, what income are you likely to be able to offer and when, what capital returns are likely and when, what involvement will you be looking for from your investor, and what wider benefits might there be if he should go ahead and put his money with you? You must decide if the cost, both financial and in terms of restriction and control, is worth it to you.

Paradoxically, the plan for Business Angels should not give everything away. You need to explain in more than enough detail to get your target's juices flowing and keen to meet you, but not everything. If you try to answer all his queries in the plan, and he's not quite understood so he doesn't ask to meet you, you'll never have the chance to put him right. You must make the target want to meet you so you can persuade him of your credentials and abilities. He might be missing out on the best deal ever: you owe it to him as well as yourself to get the plan right, and to tempt him into that meeting.

One final point to make, which impacts on many observations that follow, concerns your company if you have set one up. Unless there are compelling reasons to keep it, it is quite possible that an investor will choose to set aside anything you already have and set up a new, clean company, a 'Newco'. Any assets such as intellectual property will be assigned to the new vehicle, leaving any potential hazards behind. It will make a difference to you only if there really are hazards in the original set up, such as losses you can not recover or minor shareholders who might take umbrage. It is certainly worth keeping this in mind before spending much on a business vehicle of your choice, and might need to be factored into some of the following considerations and calculations.

8.6 PREPARING THE BUSINESS CASE

You will recall that in the section on People Risk an entrepreneur was described as 'someone who knows where he wants to get to and works out how to get there, not someone who knows where he is and has to work out where he's going'. Preparing a Plan can also be compared with a journey. If you are starting out on a journey, you will have a very clear idea of where you want to finish. It is probably an address somewhere, so you start the journey by putting in your finish point. If you start out without knowing where you want to finish, you could end up anywhere. The best Business Plans are written in a similar way: backwards. You know how much money you want to make and by when, so you know where you want to be when you exit. To get the exit price you want, you know what your earnings will have to be and what your Balance Sheet will have to look like. Of course, these will only be projections based on current comparables and multiples, but you have to be aiming at something definite.

So you know where you'll be in, say, five years, and clearly it is easy to produce current Profit and Loss accounts and Balance Sheets for your business, so you also know where you are starting from. What will the business have to look like in four and a half years if you're going to get to five as planned? And what must it look like in four years? And three years? Two years? One year?

Given where you are starting from, what resources do you need now to get there? A Business Plan fundamentally is financial: it's what the Profit and Loss, Balance Sheet and cash flows will look like at various times in the future. You have to work out in detail how you are going to ensure your journey does go from your 'now' to your desired 'then'. What are the risks, how will you manage them in order to gain your reward? What do you base your assumptions on, and why have you chosen your assumptions and not others?

Think it through: risk, uncertainty, reward; vision, stage, model, people, motivation. Can you explain what you have to offer, can you sell them? Do you understand your market backwards? And your business model? Do you have a good team, do you understand what could go wrong, and what to do about it?

Think it through: to impress someone sufficiently that they will entrust you with their money, and lots of it, you will really have to understand your finances, and especially your cash flow. Do you genuinely understand how and when your investor will get his reward, or do you simply have a vague notion of 'then we float the business'. Do you really have a game plan for the exit, understanding what it takes and how long it takes?

Even if you do all this to satisfy yourself that you have a genuinely good business opportunity, you still have to demonstrate to an investor that what you propose is deliverable, that it is not simply a pipe dream. Your CVs provide the necessary credentials, and the credibility that gives the reader the assurance that all you put before him has authority and that you know what you are saying.

8.6.1 PREPARING THE BUSINESS CASE: RISK

If you are going to succeed in obtaining investment in your business, you will have to understand how you will be perceived by potential investors. A key component of any confidence they might have in you will be provided by your assessment and management of the risks as you see them. If your treatment of risk shows that you really do appreciate what is involved in managing a growing business, you will be well on the way to getting an investor.

Don't forget, either, that great businessmen are also seen by the larger population as risk takers, and this gives rise to small dilemma. Laying too much emphasis on risk management carries the implication that there are too many risks to avoid, whereas failing to do so implies that you may not be very risk aware. Further, if you are not going to stick your neck out way beyond anyone else's, how will you achieve the extraordinary results that no-one else can achieve?

This apparent problem resolves itself when you realise that great businessmen usually do not see themselves as risk takers. They see themselves rather as good decision makers and risk managers. Bear in mind too the phenomenon of 'risk homeostasis' by stressing that you are a decision maker as opposed to a gambler, pushing upsides up while limiting downsides. So you need to present yourself as one prepared to take a calculated risk, aware of and able to cope with the downsides but doing everything possible to generate the upside.

You need to demonstrate too that you are aware in your risk assessment and management of the likelihood and impact that various risks present. Show that you are aware and competent, and you will be believed.

Go through every aspect of your Plan and assess what risks an investor would see, and treat them the same as the investor would. Give them marks out of ten to reach an overall risk assessment. Looking at it in overview, where can you improve your odds?

8.6.2 PREPARING THE BUSINESS CASE: UNCERTAINTY

Some of the financial assumptions you make in your Plan, such as interest rate and currency exchange rate, are external factors over which you have no control but which could have significant impact on your ability to keep to plan. Other assumptions are very much under your influence: debtor days is an obvious case in point. Yet others are a mixture: overheads combine external costs like utilities with your use of them, efficient or otherwise.

What are your confidence levels in choosing the values you use, what are the Uncertainties involved? It is important that you appreciate how Uncertainty impacts on the message you want to send, and most importantly that you show that you know how to interpret all this to make your proposition attractive. Introducing the concept of Uncertainty into your plan demonstrates your competence as a manager, how your ability to recognise and manage the risks that you have identified will ensure that the business goes to plan.

8.6.3 PREPARING THE BUSINESS CASE: REWARD

Ideally, use your financial projections incorporating Uncertainties to arrive at a realistic net present value for your business.

This is a really sensitive area for entrepreneur and investor alike. If you don't put something about expected returns for the investor into your Plan, many investors won't bother to read further. If on the other hand you are too cautious, or definitive, or aggressive in your assessment of the investor's reward, many investors will doubt the plan's credibility and still won't bother to read further. It is a problem to pitch it right.

Your business probably has little intrinsic value, so make sure that any Intellectual Property you might have is fully exploited in the initial valuation. Before committing yourself in words, make several valuations using every method, and compare how they each look. Be conscious that your projections are just that, projections, and your Plan is the means through which you get what you hope for it. Using Uncertainty in your reward calculations will help you find an acceptable upper mid range point, but beware that most investors will immediately use this as their initial bargaining position. Use phrases like 'the target return for an investor' and 'the target shareholding' and 'negotiable structure' so you don't fall into the obvious traps.

If your business qualifies to give any tax advantages for investors, it is a good idea to state the potential rewards both in net terms and in gross terms as not all investors will themselves qualify.

8.6.4 PREPARING THE BUSINESS CASE: VISION

Do you have a clear, identifiable and realistic vision for your business? Do you recognise that competing directly with Google, Unilever or Vodafone is unlikely to succeed, even if you only want a one percent share of the market, because they want it too?

Why is the marketplace ready for you to unleash your business on it? Is your concept revolutionary or evolutionary? What is the business focus? Does it have the ability to scale up, and how many fold? Is there any scope for horizontal growth? Are there any reasons why now is the time to move, rather than last year or next?

Can you fire the investor's imagination so that he needs to be in your future as much as you want to be in his?

Where appropriate, mention those assumptions that justify your Vision to explain why these specific ones were chosen.

8.6.5 PREPARING THE BUSINESS CASE: STAGE

To be fair, you might think there isn't much you can do about this: your business Stage is what it is, and you need money to go further.

First, test thoroughly whether there is any possibility of adding credibility to your case by advancing the business stage. Can you bootstrap anything? Can you beg or borrow resource in order to go an extra step along the stage continuum, say by proving a concept, getting a commitment, making a sale, or getting a customer's written commendation? Anything will help if it adds credibility.

If you really have gone as far as you can, you will have to convince potential investors that you have so thoroughly researched your business that despite its relative immaturity the risks involved have been minimised. You need to persuade them that your competence more than makes up for early stage risk.

8.6.6 PREPARING THE BUSINESS CASE: MODEL

Your Business Plan is first and obviously a written document that explains what the business intends to do, where, how, by when and with whom. And, of course, how much money it's going to make for whom.

All too often, entrepreneurs are so engrossed and enthusiastic about their plans that they completely forget that it is new to everyone else. We have genuinely read Business Plans where the writer did not explain what the business actually did: talk about not seeing the wood for the trees!

Never assume that your target investor will understand, or even be remotely interested in, the technical details. Mr Walls did not succeed in selling billions of pork sausages by explaining in detail how they are made; he sold the 'sizzle'. Leave the technical stuff for the appendices, or if you are asked.

Your text has to explain why you choose what you choose and what controls you have.

8.6.6.1 Preparing the business case: Model: Sales and Markets

What are you selling? What's the intellectual property position? Do you own it and have you protected it? Is there any litigation risk? Are there any technological dependencies?

How big is the market and how fragmented? How many can you sell at what price to whom and how often? How much money will you make, and are there any scale dependencies? How will you achieve all this, and how will you ensure that it is repeatable? What are the conversion ratios and is there any evidence to back this up?

Who are your customers, and will they become loyal? What are they doing now without you? How will you do this and with what marketing costs?

Is there a Regulatory or Compliance reason to buy?

What is your competition: who else is supplying or attempting to supply your intended market, and with what resource and success?

8.6.6.2 Preparing the business case: Model: Operations

Can you make and deliver your product to a price and on time? How in practice will the product be sold, made, transported, stored, delivered, invoiced, paid for and so on? What information and controls will be important in running the business?

8.6.6.3 Preparing the business case: Model: Resources

What things, space and people are needed to do all this?

8.6.6.4 Preparing the business case: Model: Finances

This is the key part of your Plan, that around which all else revolves and upon which it depends.

You will already have decided the timeframe for your business, and should have prepared spreadsheet monthly forecasts of your accounts. These will be based upon your assumptions of future business growth. This is a brief suggestion about presentation of your forecasts.

The figure for each of your assumptions will be stored in the spreadsheet in a cell, and each cell has its own unique cell reference in the spreadsheet. Link the cell for each assumption to the relevant calculation cells in the forecasts so that a knowledgeable reader using the spreadsheet software can follow the audit trail of the calculations and test the figures through the construction of 'what if' scenarios.

Next to the assumption figures enter the Uncertainty variation in the assumption. If you are competent with the spreadsheet software, use the Uncertainty figures to make variable projections ranges.

Take all necessary steps to ensure that you qualify for whatever tax breaks might be available. No investor will invest purely for tax, but you need to show competence by being aware.

8.6.7 PREPARING THE BUSINESS CASE: PEOPLE

People are the key to a successful business, and flexibility, leadership and great business credentials are key to people. In order to sell shares or profits, you need to establish that you have what it takes, and that you can provide your target investor with comfort that you can give him what he wants, with minimum personal exposure to whatever he doesn't want.

Your CVs should be a very brief business biography of between two and three hundred words. They will explain to the reader the authority the author has in writing the plan. Show the investor how your experience, knowledge, skills, capability and character will enable you to make him money using your Business Plan. And if you don't have enough of what it takes in every department, get someone to join you who has, and let him earn a share in your business too.

Whatever you do, do not try to fool the investor. When he finds anything that misleads or that has not been disclosed, as he surely will when doing his Due Diligence, he will be off.

8.6.7.1 Preparing the business case: People: Character

Make a brutally honest assessment of your character. If you can't give yourself ten out of ten, don't waste your or others' time because no-one will back you. Tough, but true. Of course, we're not talking about parking tickets or the occasional minor slip up, but we are talking about character flaws concerning trust in relationships, alcohol or drugs, or honesty. If you have any genuine doubts, talk them through with a confidant and if still in doubt, and if you can, get someone else to run your business on your behalf and keep enough shares to make it worth your while.

And while they have nothing to do with character, also bear in mind that any issues, or potential issues, with your health and age will need to be similarly addressed; don't give investors any excuse to introduce doubts.

8.6.7.2 Preparing the business case: People: Experience

You can't fake experience, but you can make the most of what you have. If you really have insufficient for the tasks you are proposing for yourself, get someone else involved who can help.

8.6.7.3 Preparing the business case: People: Knowledge

This is obviously one area you can influence, and especially if your experience is low you need to score highly here. However you do it, you need to score at least eight out of ten between Experience and Knowledge.

8.6.7.4 Preparing the business case: People: Capability

Capability is probably the most difficult competence to demonstrate unless you have a good track record in management. Without that, all you can do is ensure that your Plan is as expertly written (by you!) as is possible. If in addition you can attract other competent managers to join your team, or act as champions for you until they join your team, at least your emergent Capability will be on show. You will need to show at least seven out of ten when combining experience, knowledge and capability.

8.6.8 PREPARING THE BUSINESS CASE: MOTIVATION

It is extremely difficult to prove something that hasn't happened, yet what the investor wants is proof that you will be motivated after his injection of cash. Your record to date in this project or other projects you have been involved with gives him a track record, which is very indicative. Indeed, if it is sufficiently impressive it should do the trick. If not, be prepared to negotiate terms which prove you have what it takes. These can include performance based share options, ratchet mechanisms, buy back clauses, or anything similar as we discuss later in the section on Doing a Deal. Beware, though, that all complications of this nature can be expensive to implement and can have unintended consequences.

8.7 WRITING A BUSINESS PLAN

8.7.1 WRITING A BUSINESS PLAN: STYLE

Does the first page make the reader want to find out more?

Great entrepreneurs don't have to be great writers, but keeping it simple and clear is a must. Make sure you don't blind anyone with jargon. Jargon isn't clever, it is confusing. It can also be counterproductive as it could well hide your brilliance. Don't let bad writing obscure your brilliant ideas, and don't give the investor any reason to put it down.

Be very careful: go after the money and the man will run a mile; go after the man and he will bring his money with him. The plan is written and expressed specifically to address the issues that the target might have, and to appeal to those of his instincts that will motivate him to say 'Yes'. So a plan for target A may well be inappropriate for target B, and so forth. It has to be written with cunning. You wouldn't make a sales pitch to any company using a different company's data and branding, would you? And, because the investor does not exist who does not want to reduce his exposure to risk, he will almost always try to share the risk with other funders. Inevitably this means you may have to write two or more versions of your plan, each appropriately tailored.

Understand your target, understand how much detail he will need, and what detail. Consider your target's personality and concentration span, so write to appeal, not bore or overpower.

Treat your target as very intelligent but ignorant. This means that you have to explain everything clearly, but also that he is very quick on the uptake so do not labour any points and explain just once, briefly. Remember that every Business Angel will be looking at dozens, perhaps hundreds, of plans so it is essential to keep it as short as possible without leaving out anything important. Remember that Winston Churchill said, 'I am going to have to make a long speech tonight because I've not had time to write a short one'.

8.7.2 WRITING A BUSINESS PLAN: CONTENT

You prepared your Business Case backwards, starting from where you plan to end up and showing how you plan to get there.

We suggest you write it the same way: what is in it for the investor, details of any legal entity you have set up or propose, what are your objectives, how you plan to achieve them, what might get in your way that you will have to overcome, what evidence you have to back you up, what credentials you have to speak with authority.

In your spreadsheet projections, state the assumptions and uncertainties in a separate worksheet so it can be printed off as a self contained printout, as shown below in the first table. You should now have a sheet of assumptions, each variable by a stated uncertainty, linked to forecast Profit and Loss, Balance Sheet and Cash flow sheets for the duration of your proposed Plan.

The example in the second table below shows only the Profit and Loss projections with a limited range of Sales, Cost of Sales and Costs entries. Of course, there could be many different entries, not least Tax if any becomes payable: this is not to show what to put in, but to show how to show it.

	Start	variation	Growth	variation
Sales Units		+/-%		+/-%
Sales £		+/-%		+/-%
Unit Sale Price £		+/-%		+/-%
Marketing £		+/-%		+/-%
Payroll £		+/-%		+/-%
Sales Lead Time		+/-%		
Capital Expense		+/-%		
Cost to produce £		+/-%		+/-%
Creditor months		+/-%		
Debtor months		+/-%		
General O'heads £		+/-%		+/-%
Stock turn months		+/-%		
Interest rate		+/-%		

Over the projected timeframe, here forty months, there will be some months at the beginning where you are just spending money. At the end, before you sell the business, you will just be making money. In

Months		0 12 15 18	21 22 23 24 25 26 27 28 29 30 31 32	35 38 43 48
Sales In-come	Total			
Cost of Sales	Total			
	Gross Profit			
People Costs	1			
	2			
	3			
	4			
	5			
	6			
	Total			
Operations Costs	Travel			
	Comms			
	Office			
	Insurance			
	Energy			
	Fees			
	Total			
Sales Costs	Marketing			
	Salesmen			
	Total			
Finance Costs	Total			
Capital Ex	1			
	2			
	3			
	Total			
	Total Costs			
	Net Profit			

the middle is the interesting bit: what changes, when and why. Of course, the relevant 'interesting' months depend on the plan, and may be more than twelve: however your plan works out, keep to the principle of maximising interest with brevity

The projections should show these 'interesting' bit month by month, while including the months at both ends in only summary. The Balance Sheet and Cash Flows should be in the same format, but may well not cover exactly the same months. And if they don't, you will need to explain briefly in the text why not and what the implications are.

Finally, and especially, investors do not like surprises. If you have anything which could come out unfavourably in due diligence (usually track record, but could be anything) get your retaliation in first by explaining it your way in the plan. It might be hard, but it is so much better than if he finds out afterwards.

8.8 PRESENTING A BUSINESS PLAN

Front page: is for a sound bite summary addressed to the investor with "What's in it for You": it is designed to make him want to read on. Don't use the front page for just a title, because the target can forget a title but he won't forget 'What's In It For Me'. If appropriate, indicate potential returns both gross and net of tax.

Page 1: heads off with the executive summary of 2–300 words explaining the investment opportunity (not the business!): who, why, what, where, when, how, IPR, how much is needed with what returns.

Pages 1 to 9 (yes, that is 1 to 9 and not 19 or even 10): The text explains What (Vision), Why and Where (Sales & Markets), How (Operations), Using What (Resources), How Paid For and controlled (Finances) and by Whom (People). The commentary needs to excite the target in the way you intend: hit his hot buttons, whatever you have decided they might be. Your analysis of strengths weaknesses opportunities threats should ideally be simply part of the text, where you explain how you arrive at both the assumptions and the Uncertainties shown in your spreadsheet printouts, and how you manage the variations if – when! – things are not on plan.

If you also provide a projection of cash flow and profits graphically, highlighting the 'interesting bits' when you are expecting things to be happening, it demonstrates your awareness of the major business issues.

Page 10: CVs of Principals

Page 11: Single spreadsheet page detailing all the assumptions and Uncertain variables in the forecasts, as above

Pages 12 to 14: Profit and Loss, Balance Sheet and Cash Flow are each a single landscape spreadsheet page forecasting by year/month for 12 months around the minimum, as above in the second table.

Appendices could be omitted in the first introduction of your plan to the target investor, and if not omitted should be as short as possible; but if you have a 'thorough' type of personality – high in Steadiness and Conscientiousness, see the section on People Risk: The Team – and are targeting a similarly styled investor you should include Historical Accounts (if relevant), any Technical information and what Market Research details add substance to your proposals. Other investors will ask for the appendices if they want to see them.

How many versions should you write? You will need several, especially short summaries if you are going for Business Angels. Business Angels will ask to see various lengths of your plan: some will want the full works, while others will not want to read all that but 'please just send me a 2-pager'.

So you will need a 50-words 'sound bite', a 200 worder, a 500 worder, a 1-pager, and a 3-pager as well as a full plan. Make them all exciting to read, full of interest and potential, without being over the top.

8.9 THE PITCH

There are three kinds of pitch. The first is wholly informal, which you never know can lead to surprising new contacts and networking.

Remember that you are selling a share in your business, not 'widgets'.

8.9.1 THE INFORMAL PITCH

Most of the time, you will be unprepared for a pitch. Why?

Because, most of the time in some unexpected situation someone will innocently ask you 'What do you do for a living?' and you will blather on for a while, then give up, probably when they lose interest.

And not merely is that not very socially clever, it is a real waste of an opportunity. So put as much effort into your pitch as you do into your plan. Prepare and practice sound bites, so you are never caught off guard if someone casually asks. It's what you will be measured on: how you present. Practice, feedback, think: again, again and again! As Lord Birkenhead said of Winston Churchill: 'Winston has devoted the best years of his life to preparing impromptu speeches'.

8.9.2 THE FORMAL PITCH

Then there is the highly formal prepared Pitch which must last for exactly so long in front of an audience of Business Angels. These are always worthwhile, and several Networks organise formal Pitching events. Even if you don't raise money there, the practice is invaluable.

This main Pitch is when you are trying to interest someone who has not yet read your plan, or at most a brief synopsis put about by the Network, and the purpose of your Pitch is either to get the investor to want to read it, or better still to get him to a meeting.

The Pitch should not be a verbal repeat of the written plan, because people respond differently to speech, but it should, of course, be based on the written plan with these important variations:

Tell them what you intend to say (introduction)

Tell them what you're saying (main Pitch)

Summarise with what you just said (summary)

Keep it simple, cover the essential points ("What's in it for Me" what how much when why how where and who)

As with the written plan, work on various versions. Get your 'sound bite': 'I do 'XX' and I need £YY to do it. And I'm looking for someone who can add more than money: I need a ZZ guru'

Do a 5-minute, a 10-minute and a 15-minute version.

And do a version that allows greater flexibility, for when you are talking with your funder target informally.

If you want to do a PowerPoint presentation, please do not simply reproduce on your slides what you are saying. Use fewer slides than you think ideal, and put the main salient points in big letters. Your talk is to explain the slides, and your slides are to illustrate your pitch. Use pictures, graphs, diagrams but as few words as possible. And whatever you do, do not read them: you should be facing your audience and wowing them, trying to get the odd eye contact for feedback and to initiate relationships. Smile!

Remember that when you are talking, you are saying what you think you should say. When you are answering questions, you are addressing what your audience wants to hear. There is a big difference.

So never take up more than half of your allotted time on your Pitch: then invite questions from the floor. In your Pitch, leave details unanswered: leave that for the questions. When answering questions, answer fully but briefly: solicit more questions, don't go on and on. Aim to get as many questions as possible, so answer each as briefly as you can without being rude or incomplete. If you can do this, you will impress the audience and you will have a queue to talk with later.

8.9.3 THE SPEED PITCH

And finally there is the pitch you will need if you attend any of the 'Speedfunding' type of events that are often arranged by Business Angel Networks. Investors sit at tables and entrepreneurs join them in turn for a set time depending on how strictly the event has been arranged. You usually have, say one or two minutes in front of each investor to make your case, then swap tables any number of times. This tends to be a combination of a very brief formal Pitch and the meeting, in that you use some of your available time to make a set pitch, then have an equally brief informal chat to establish human contact. The idea here is to get the investor to want to follow up the introduction with a lengthier meeting.

But even though pitching comes in three types, they are the same in principle: they need practice, and more practice! Remember you want to give him the information he wants, so be 'coy' and solicit questions, rather than telling him what you think he wants. Keep your pitches short, keep away from detail and work on several versions. Nothing to it, really….

8.10 THE MEETING

Finally, we come to the Meeting when you meet your target investor in more-or-less informal surroundings when he will try to find out what it is that makes you tick. This is similar to the Pitch, but informal: keep to the point and do not bore with lengthy answers.

The investor may well try, possibly quite subtly, to put you off. Don't be surprised if he refuses to listen to a prepared pitch in a meeting: he may well simply say 'Yes, I understand all that. But I want to find out if you understand it too without notes or prompts'.

Remember that he's not trying to find out about your business, he's trying to find out about you, and if he likes what he sees, he's going to decide if he can both trust his money with you and work with you.

It's worth repeating: you are not selling widgets, you are selling yourself and your ability to make money from widgets, especially when it goes wrong. Which it will. To get across the right message you need to ensure that the investor really understands that you understand not just your business, but the business of business: you want him to back you and not your idea.

You will be tested with the awkward questions; about your assumptions; about your credentials. And investors will always listen closely to your answers: how flexible is your approach? Can you cope easily with challenge? Will you be amenable to working closely with them, or will you insist on doing your own thing exclusively: can you learn, or do you give the impression that you already know best?

He will pick out something to ask you about, it doesn't matter what, to see if you really understand your plan. He will test your case to destruction, and not wholly to see if it does destruct but to see if you self destruct too when under pressure. Know the business inside out: and if you need your right hand man with you because he's the one who understands the money side, or whatever, take him with you. No investor of any colour will put his money your way if you even look like you're not on top of your game. No excuses.

Do your rehearsals before the meeting, and not with the investor. Do not even think about 'winging it'. You won't get two chances.

Remember that everyone else who is looking for money is muddying your waters. To have the best chance of success don't spread your plan around: do research and target only likely takers, and if you use funding intermediaries make sure their brief is specific: there's nothing quite so damaging to a plan than for an investor to receive multiple copies from different sources. Make sure you manage investors expectations and especially do not hide surprises; only ask for a confidentiality agreements if essential, and you will find that larger companies and Institutions may be unable to sign them because of their size.

9 DOING A DEAL

In which we look at the process of constructing a deal with many associated considerations for both sides

9.1 WHAT ARE THE RISKS

After both entrepreneur and investor have decided that on balance they like each other and there is a deal in the offing, unfortunately things start to get even trickier.

Many potential investments founder from this point on, and not always because investor and entrepreneur can't agree the terms of the investment. There are many other factors that come into play, some of which they realise were easily avoidable only after it is too late.

Research done by Professor Colin Mason is very relevant here. Colin Mason is an economic geographer who has done a lot of research into Business Angel investing. It is interesting for both sides to note what he found when he asked Business Angels about their experience a year or so after having struck a deal. A whopping 37% say that they should have done more due diligence. Frankly, we are not so sure that what they didn't mean is that they should have done *better* due diligence. There is a world of difference, and use of Risk Reward and Uncertainty would have made their decisions much more insightful.

In addition, 13% wanted more control of contract terms, 9% thought they had made a mistake with the investment, 8% believed the business had underestimated its cash needs, 6% wished they could get rid of the entrepreneur, and 4% said the entrepreneur was too out of control; 18% admitted to more than one of the above. In other words, nearly four out of five didn't think they had got it right in one way or another. More care and better methodology, not more time, could have made a big difference: and being forewarned is forearmed.

9.1.1 WHAT ARE THE RISKS: TIME

Wasting enough time to prejudice a deal is far more common than one would imagine, but it is never (well, hardly ever) deliberate. Indeed, the guilty parties would insist that they are not wasting time, simply being thorough. For entrepreneurs, the deal is normally very badly wanted. For business reasons, because impatience goes with the entrepreneurial territory, and because many entrepreneurs in fact have little idea of how long and tortuous the fund raising process can be, by the time they are getting to the negotiation stage they are beginning to lose it. From their point of view, the deal is urgent and they want to get on with the running the business. For them, raising funds is a necessary but time consuming distraction.

But the serious investor might still be making up his mind between a few competing opportunities, and will not be rushed. In particular, any suspicion that an entrepreneur is pressurising him is likely to backfire. Of course there can be clear external deadlines, such as season, trade fairs, and so on that are unavoidable, but even so most investors would prefer to lose the opportunity than to be rushed beyond their comfort zone.

Many investors will refuse to be a sole investor in any opportunity, and readers will already know that in any case we advocate having several smaller investors acting together rather than any individual making one larger investment. If this means that there are insufficient funds available, it brings its own delays while more investors are found to join the deal. And they have to be found and converted into investors before the earlier investors tire or invest elsewhere, a phenomenon known as deal fatigue. Unfortunately, it happens.

A common feature among more fearful or analytical investors is enquiry paralysis, also known as 'Paralysis by Analysis'. They will spend far too long worrying over hypothetical details in endless 'what if' scenarios, dealing with situations where there are risks of loss that are unlikely to occur. If they don't assess and prioritise risks and uncertainties properly, so much time can be lost that deals fall through.

Both entrepreneurs and investors also tend to get hung up over control when negotiating valuation, each demanding a share of the business that allows either positive control of the business or power of veto. The entrepreneur will want to keep as much as he possibly can, while the investor equally will want a larger share than the entrepreneur is prepared to let go. Both are wrong, in terms of control. Valuations and shares should only reflect reward; control can be determined by the Shareholder Agreement rather than by shareholdings.

9.1.2 WHAT ARE THE RISKS: COSTS

Another major risk factor, especially in smaller deals, is that the costs can so easily go into a self sustaining spiral of excess. It has been said that 'accountants, lawyers and professionals are the absolute antithesis of entrepreneurial activity'; to be fair, this statement may be true, but if so it is only among those professionals who have no experience of Business Angel investing.

9.1.3 WHAT ARE THE RISKS: BAD FAITH

Lack of trust most certainly runs both ways.

Investors, obviously, want to put their money into the business that they believe they have seen from the Plan, run honestly by a highly motivated and competent entrepreneur or team. Quite rightly, they will insist on satisfying themselves that any deals they sign reflect that. We have only ever met one entrepreneur who deliberately had bad faith. He had very dubious rights to the intellectual property he claimed as his own. Usually, entrepreneurs fall down through naivety, their inexperience and naivety leads them to believe they have a greater competence than is the case. Proper due diligence quickly sees through such firmly held, but innocent, falsehoods; and if the opportunity is still sufficiently good, and the entrepreneur realistic, all might not be lost.

Equally, entrepreneurs want to make sure that they are getting exactly what they bargain for, no more and certainly no less. They do not want to lose their 'baby', they do not want suddenly to be told what to do, and they definitely want all the money they ask for. They do not want to incur additional costs, and they do not want to discover that the 'investor' offers to join them without cash and is really after a job in exchange for equity. Believe it or not, we have come across one scam where the 'investor' was simply charging fees for his due diligence before turning the deal down. Others promise money, then decide that their expertise is what is really wanted for 30% of the business. Nice work if you can get it! Investors may see it as impertinent, but so what. To avoid such pitfalls, entrepreneurs should also do due diligence on investors.

It is therefore critical for the success of any deal that both sides enter in good faith. Misunderstandings, misinterpretations, and bad faith can be avoided by clear communications, and if either side shows indications that they are playing a game, or are on a different agenda, call it off and put it down to experience. Better to have wasted some time than to have wasted some time and a lot of money too.

We look at issues of non-disclosure later, but it is worth mentioning that obviously if there are any matters that might be controversial or worse, they must be disclosed early. Not only does that give the best chance of success through a fair hearing, but failure to do so is a deal killer and will waste both time and money.

9.2 NEGOTIATION

Ideally don't negotiate at all, perhaps by using a 'put it off 'til later' strategy as we explained in the section on Reward. If you must negotiate, then do it quickly because if it gets protracted the relationship isn't working.

Ideally just the principal and investor should sit round the table, but include your and his lawyers and have one expensive meeting if that's what it takes: these deals are too small to bear heavy legal fees, and this approach will be cheapest and quickest in the long run. Ensure that both parties have competent lawyers, which can be much trickier than it might seem. Don't give the lawyers any excuse to rack up fees, ask for their advice at the right time and definitely before committing, and certainly don't let lawyers do any independent negotiating.

Do the deal between principal and investor, checking with the lawyers only on points of law and for ideas on process and precedent. Put on the table your deal breakers, things that will stop you from proceeding, and a list of your other wants. If the deal breakers are in conflict, stop now and spend no more time. If they can be accommodated, negotiate for your wants and be prepared to compromise: a good deal is one where both parties are equally happy and equally hurting.

Are there any contingency Plans to mitigate the downside, and how are they being defined and measured? Are the risk factors too unknown, or too uncontrollable? Should there be others involved to reduce isolation risk? Is the structure as simple as possible? Is the model in need of tweaking, and is it better to agree now how this should be done? Is the deal contingent on any other factors, such as securing other sources of funding?

Use the Heads of Agreement as a template for discussion, and leave nothing undone or unsaid. Keep and sign a copy each of the written minutes, and either use them directly as the Heads of Agreement or instruct the lawyer to use them to draft a formal version.

Bear in mind that we said "instruct your lawyer". Do not ask him for more advice, he should already have provided all that is needed. His job is specifically to express your negotiations accurately and legally. If you have not already involved him, most of the time a decent lawyer will recommend that the deal as agreed does not go ahead without amendment. He will have his client's – your – best interests at heart, but his job is to express the agreement in legally correct terms and not to try to influence it after the event. Don't vary the terms of the deal afterwards, and especially don't let your lawyer get stuck into arguments with the other lot over semantics. That almost always ends in tears for deals of Business Angel size: see our note on 'Lawyers' later.

Be aware that a second round funding may well tear up all your plans anyway, so don't get too entrenched.

9.2.1 NEGOTIATION: CHECK LIST

This is more-or-less a check list of things either or both sides should bear in mind and come to agreement over:

Valuation

- Cross check and sense-check valuations, and don't let control influence reward considerations.
- Returns should be fair for the risks being taken
- Investors should try to reduce exposure to risk while increasing potential reward
- Investors should decrease the sum invested in shares for the same percentage of the company, and instead use repayable debt, maybe with a coupon, maybe only repayable at the exit
- If the principals are adamant that the investor's assessment of risk is wrong, maybe use a ratchet, options or buy back arrangement, but don't let it impede a successful exit or get complicated

Control

- If control is not in line with reward, what kind of structure or agreement is needed?
- How involved should the investor be in the day-to-day running of the business
- Are there any areas where power of veto is needed
- How big is the board, how many seats for investors
- How closely involved is the investor in company strategy
- Who has what control over expenditure including recruitment: who signs cheques
- Where is the line between help and interference
- What reporting requirements need to be in place? The investor should insist upon regular management information

Relationships

- Stakeholder Isolation: is the investor to be alone representing investors
- Respect is needed both ways if the business is to succeed
- Both sides need to recognise the other's contributions and added value
- The investor especially will want zero reputation risk if things go awry
- Make sure there is adequate and appropriate insurance in place, such as Key Man cover, etc.
- Get tight and simple service agreements

Motivation

- Is the principal's downside relatively worse than the investor's
- The principal should be wholly focussed on success, with no potential alternative to fall back on in the event of failure. This is especially relevant where there are several different elements to the IPR or business: the investment has to be into the top holding vehicle, and not into some subsidiary. The principal should have no option but to ensure the success of the investor's business interest.
- Should the investor get a salary or directors fees
- What should be the principals' pay and benefits limits
- How involved with pay levels should the investor be and for how long
- Do you want to make money? If so, the deal should be structured to encourage the principals to make even more money, while minimising the investor's exposure to loss. The investor could increase his percentage shareholding so long as it doesn't hit motivation too hard: the business still has to work
- Even success is a risk, maintaining management motivation towards an exit and against a lifestyle business must be factored in

Exit

- How long are you prepared to leave the investment in the business
- Anti-dilution rights: with early stage growth capital, further funding rounds are almost inevitable. Be prepared for dilution: both investors and principals often get concerned about anti-dilution measures against second round greed. It's rarely worth it: further round funders are almost always professionals who will know exactly what they need from a deal. They will insist on an agreement being torn up if they want to, and you'll either live with it or walk away. Either way it'll probably cost.
- What kind of exit strategy is desired
- How realistic are the contractual obligations concerning exits: can they sensibly be exercised
- If an exit is forced under duress, how will it impact upon the business
- Is it practical and sensible to include warranties regarding exit
- Should either party have right of first refusal
- Are the exit options both sensible and thought through and genuinely desired by the entrepreneur, and will it stay that way
- What is included so the management can get rid of an uncooperative investor
- Drag and Tag:

- 'Drag' rights give the shareholder the power to insist upon a sale even though co-shareholders might be against it. This can be important either to get a sale at all, or in the event that the purchaser insists on a minimum take up (often 100% in unquoted companies)
- 'Tag' rights give the shareholder the power to insist upon being included in a sale, even though the purchaser might not have made an offer for his shares. This would be important to avoid being left with potentially hostile co-shareholders and no prospect of an exit.

Further investment opportunities

- Does the investor want, can he have, access to other of the entrepreneur's winners
- Should the investor have pre-emptive rights for future subscriptions

Spread risk

- Share the risk with others: other investors (especially wise ones), loans, grants, tax breaks…think of all the possible alternative sources of funding, but not so as to prejudice the deal through unnecessary delay

Timescales

- should be realistic and definitely not too drawn out

Structure

- Avoid complex structures and offshore arrangements; life's difficult enough, so keep it simple
- Ensure all involved parties have the same motivations and rewards
- Avoid multiple share structures for different investors without excellent reason.
- The investor will want minority protection rights at the least

9.2.2 NEGOTIATION: STRUCTURE

Get a simple corporate structure. Below is a table which outlines the advantages and characteristics of various different kinds of investment vehicle: ordinary shares, preference shares and convertible loan notes. The list is not exhaustive, but shows all the less exotic variations; alternatives are likely to be more complex and cost more to set up. It has wisely been said that 'You use preference shares to attract capital and ordinary shares to attract staff'.

Characteristics of different types of Investment with acknowledgement to Van Osnabrugge (1998)				
	EIS?	**Effect on Exit**	**Downside Protection**	**Upside Potential**
Ordinary Shares	Yes	None	None	None, other than that acquired at outset
Ordinary Shares with pre-emption and tag-along rights	Yes	None	None	Investor has rights to invest further, and Principal can't exit without investor also having the same chance
Non voting Ordinary Shares	Yes	None	None	As Ordinary Shares, but affect control
Options	No	If performance based can help	None	If performance based can help motivation
Convertible Preference shares	No	Complex terms can impede second round funders and/or exits – eg IPOs	In event of success, investor has downside protection – but not in failure. Further protections could be built in	Usually makes upside potential easiest to exploit
Convertible Loan Notes	No	Facilitates VC round – which is excellent for exit	In event of failure, investor has maximum available protection	If loan note conversion terms favourable, offers excellent upside to investor

Loan notes	No	None	None	None, but returns certain in event of success
Debt	No	None	None	None, but returns certain in event of success
Performance-based Milestone funding	Depends	None	Limits cash loss	Ensures investment is aligned with performance

Does the structure impact upon the relationship between principals and investor, and prevent misbehaviour? Equally, is it wholly aligned so that everyone is always pulling in the same direction, without conflict? This can sometimes be especially difficult to achieve if using certain motivational reward structures.

As mentioned earlier, one way to overcome differences in valuation is to bridge them using ratchets or options, giving the management extra for performance or costing them shares for failing to meet targets. Ratchets based upon performance may well backfire if they are too onerous, so after a while management can't see their rewards ever being realisable and give up. Ratchets can be based upon exiting within a defined timeframe to act as a spur to performance, but if it turns out that this is not aligned with actual performance it may well be counterproductive: imagine the impact on management motivation if the structure gives them a bonus for exiting within five years, and after four years they realise they won't quite make it. Using options is more efficient than a straight ratchet structure, but beware falling foul of tax legislation. Ratchets can also be complex, and hence expensive: as a rule of thumb, they're best avoided.

Having a structure that is designed to reward management performance not only has a positive motivational push, it also avoids a potentially big downside. Remember Risk Homeostasis: if you push someone too hard into a box, he'll possibly feel the need to risk going 'out of the box' just to prove he can.

Does the structure provide some comfort in the event of failure, and lead to more opportunities in the event of a winner? Does it facilitate and speed the chance of a lucrative exit? Is it optimal for next round finance?

Note that, unlike in established companies, any form of debt including Loan Notes has no downside protection as there is nothing of any substance to do the protecting. Interest rates attached to the debt can be whatever is agreed the business can stand, but unless the business will be generating cash very early the interest will be paid in a 'bullet' only on exit, or after long enough for there to be cash in the business. If payable at a later date or on a specified event, it is better for tax purposes not to make the interest accrue annually. Preference Shares are redeemable by a company only out of post-tax profits, which is good news if the business succeeds but in the event of failure again there is no protection.

Performance-based Milestone funding can be very helpful both in limiting cash losses and in motivating towards achievement. Unfortunately, many business models don't lend themselves easily to this approach, but phasing the agreed investment upon achievement of certain milestones within specified agreed timeframes works well if it is applicable.

9.2.3 NEGOTIATION: DIRECTORS' DUTIES

Almost every investor will want to have a say in how his money will be used, and at the very least this normally means having a seat on the board of directors. But it's not all plain sailing, it is essential to understand what this means in terms of legal and tax implications. Everyone, including investors, appointed as directors do have exposure to certain liabilities, especially under the 2006 Companies Act. Despite an investor's concerns for 'his' investment and his feelings as a shareholder, he is obliged by law to exercise his fiduciary duties to act in best interests of the company.

Being a director can also have a major impact upon an investor's ability to act as Director for a listed company. If a Business Angel investee company should fail, there is no amelioration just because the company was 'high risk': a company failure is a company failure, and goes on record.

And deciding not to register at Companies House with a form AP01 need make no difference whatsoever: investors must be very aware of Shadow Directorships, especially if they or their appointees sign cheques or can be shown to have influence over company policy and behaviour.

Note too that the Inland Revenue can consider non-executive directors to be employed under IR35, so be wary of getting caught for income tax on shares acquired 'by reason of employment'. This can be doubly galling as under Employment Law, non- executive directors are not treated as employed. It is the worst of both worlds.

Some serial Business Angels have considered creating a special purpose limited company in order to appoint it as Director on their behalf, but even that may not change their treatment by HMRC or the regulatory authorities.

9.3 THE PAPERWORK

'Tidying up the legals' may be how investor and entrepreneur see it, but the documentation is extremely important. Not only does the paperwork have to reflect the deal investor and principal have agreed, but it also needs to be between the correct parties, to pre-empt all the problems that might arise in the future, and to provide a framework for dealing with them. It must be appreciated that the devil is in the detail, and it is essential that everyone keeps patience with the process.

One excellent source of reference is the TomsLaw web site found on www.fisma.org. Lawyer Tom Mackay founded FiSMA and the TomsLaw website to give free precedent documents to entrepreneurs and their investors. Its Document Library publishes a variety of downloadable template legal documents covering a range of activities relating to the business of Small to Medium sized Enterprises and those planning to invest in them. It should be stressed that the documents featured on TomsLaw "do not constitute legal advice. No legal or business decision should be based on the content of their documents. For legal advice you should contact your own solicitor."

It would also be a good idea to flush out all the possible factors that should be taken into account in doing the deal such as IP, litigation, contracts, employment and so forth that are often real headaches just waiting to happen. These are collectively known as Legal Due Diligence, and also include such matters as checking any existing corporate and commercial agreements, confirming the existence title and status of business assets like plant, machinery, stock and property, any lease terms, employees' contracts and rights, any existing or threatened litigation, anything relating to the Inland Revenue such as tax PAYE and VAT, all existing or necessary insurances and claims, any compliance matters, etc. etc.

Thankfully, and unusually in the Business Angel process, it is not the investor's job to assess these risks: lawyers will do that. It's what their Professional Indemnity insurance is for. It's the lawyers' role to construct the paperwork in a way that achieves both investor's and entrepreneur's objectives without conflict.

9.3.1 THE PAPERWORK: HEADS OF AGREEMENT

Before getting too far into the 'legals', a non-binding and 'subject to contract' Heads of Agreement should be drawn up between the parties at their minuted negotiation meeting, ideally without getting the lawyers too involved yet. It is a moral commitment, but usually only the confidentiality and exclusivity clauses have legal status, plus payment of any agreed fees if relevant. This will clarify the main issues and areas of understanding, and provide the lawyers with a mutually agreed framework.

Keep it simple. Ideally it should be possible to get the entire agreement on one page.

It is a basic agreement to outline the key investment terms and objectives, and to protect the entrepreneur. Other than in exceptional circumstances, it will have to be signed before due diligence can start and more definitive agreements drawn up.

The Heads of Agreement should at a minimum cover:-

- Who are the legal parties
- Share structure and share rights (in particular with regard to any preference convertible or redeemable shares)
- Priority rights over other shareholders
- Amount invested and structure of investment
- Entrepreneur consent issues and minority shareholder protection rights
- Information rights
- Appointment of directors
- Use of the funds using SMART (specific, measurable, achievable, realistic and timely) measurements; these can be called the Critical Success Factors
- Any matters to be excluded other than with investor's consent
- Exit strategy, with what safeguards
- Fees and expenses with whose responsibility is what (but note Company Law with regard to Financial Assistance as modified by the Companies Act 2006)
- Exclusivity clause for a specified time
- Access to records, customers, suppliers and staff for due diligence (for obvious commercial reasons, this can sometimes be difficult to arrange with going concerns so it needs to be thought through)
- Confidentiality clause
- Timing of completion
- Any proposed dividend policy
- Get-out in the event of change in circumstance

Plus whatever either side can get agreed from his wish list.

9.3.2 THE PAPERWORK: DISCLOSURE LETTER

Once the Heads of Agreement have been signed, the lawyers should be instructed to get going. First thing they will do is to start dissecting everything. They will ask the entrepreneur for information about the business: any and all paperwork he has to confirm whatever he has claimed in his presentation, Plan and agreements. The Disclosure Letter contains, or should contain if it is being honest, all the key information about the company.

This should throw up any previously undiscovered or unnoticed problems, which can exist without prejudice. So long as they are not deal critical, and they shouldn't be, these can easily be coped with. They usually arise because they weren't even considered by either party, or thought too insignificant. But the lawyers will dig them up. The aim is to reduce the scope of any later warranties or indemnity protections that might otherwise be required.

Both investor and entrepreneur should make full use of fact finding techniques to flush out any potential problems now while they can be catered for and before they become real issues.

If there should turn out to be any last minute disclosures of even minor (as opposed to no real) significance, the other party should seriously consider pulling out, or delaying matters to negotiate specific indemnities. If anything is held back now, what chance does the relationship have in going forward?

9.3.3 THE PAPERWORK: CONFIDENTIALITY AGREEMENT

Lawyers will also want both parties to sign a Confidentiality Agreement to ensure that any information disclosed during the negotiations must remain confidential. It may not always seem relevant, but it is clearly so if the deal involves an ongoing business or start up where sensitive matters are to be disclosed and where the other party would be able, if so minded, to use the information for his sole advantage.

There will, or should be, exceptions in relation to some information. This includes anything that is already public knowledge, that you can prove that you already knew, that is generated by third parties, that may be required to be disclosed by law, or that has to be disclosed to advisers. In that case, the advisers will also be required to be bound by the same terms. If there is no time limit to the agreement you are asked to sign, you should seek to limit the duration to something pragmatically sensible.

9.3.4 THE PAPERWORK: LOCK OUT/EXCLUSIVITY AGREEMENT

An exclusivity agreement is a contract between the parties to give each other the security that they will deal only with each other. There will be a specified timeframe involved, sufficient to allow due diligence to be done and the deal to progress without binding the parties to each other permanently. It takes things to the next level of commitment, while allowing for the deal to fall through and both sides to explore other avenues afterwards.

9.3.5 THE PAPERWORK: SHAREHOLDER AGREEMENT

If all goes well and no deal breakers emerge things come to a head with the Shareholder Agreement, also known as the Subscription Agreement. This contains the main terms of investment:

- Parties involved
- Investment
- Payment terms
- Number and class of shares and particular share class rights
- Loan Notes
- Control and definition of shareholder rights
- Minority shareholder protections
- Preference share rights
- Dividend rights
- Conversion rights
- Rights for further investment
- Obligations of management, including membership of mentoring groups (see Mentoring: Peer-to-Peer)
- Performance measures
- Information rights
- Inspection of records
- Insurances and protections
- Employment, key employees and service contracts
- Warranties and indemnities
- Penalty clauses for material default
- Representation rights
- Winding up or dissolution
- Exit policy
- Anti-dilution measures

The entrepreneur should make the agreement as protective as he possibly can, while the investor will try to make it as onerous on the entrepreneur as he can without killing his motivation.

Some of the provisions may instead be contained or repeated in other documents, in particular Employment Contracts and the Articles of Association.

9.3.5.1 The Paperwork: Shareholder Agreement: Warranties, Indemnities, Newcos

Warranties are guarantees that defined 'things' are as stated, and indemnities are a promise to reimburse the Investor in the event that they are not. Where there is no significant existing trade or history, you should consider cutting enquiries, warranties, indemnities and costs to a minimum by creating a Newco Ltd. If you go down this route, the lawyer will consider the tax, contract, IPR and other implications.

Warranties and indemnities usually cover specific historic risks: environmental risks, doubtful book debts, repayment of loans, product liability claims, and litigation for infringement of intellectual property are common.

Something to bear in mind, though, is that many, if not most, Business Angel investments will back entrepreneurs who do not have significant personal means: what they might once have had has been sunk into their project. So of what use, beyond spite, is an Indemnity? When enforcing it means little more than incurring legal costs in order to bankrupt someone, is it actually of any merit?

One practical suggestion is to determine that the principals lose both their jobs and any share options (actual shares cannot be taken away). This approach can have far more influence on keeping a founder-principal on the 'straight and narrow' than the threat of losing money that he doesn't have anyway.

9.3.5.2 The Paperwork: Shareholder Agreement: Key Employees & Service Contracts

As with everything else, the day-to-day working relationship between management and investor needs to be negotiated and agreed before investment. New management contracts should tie in with the equity and other arrangements, and new restrictive covenants for key employees both during the investment period and after exit should be drawn up. Depending on the maturity of the business, there might also be a need to restrict employee shareholders' ability to sell their shares, for example by imposing a system whereby the ownership of the shares vests gradually.

Employee contracts usually also contain restrictive covenants on management, specify any financial information to be produced for the investor, and any performance related system such as ratchets bonuses and penalties.

9.4 LAWYERS

There are many excellent lawyers around, but unfortunately too few of them specialise in Business Angel activities. The modest fees to be made on deals this size barely cover a law firm's costs, so those firms that do this work will hope for a much longer and more lucrative corporate future with the business, and why not? But what this means is that it is worth double checking a firm's credentials, as no-one wants to pay high fees for a lawyer to learn on the job; and especially no-one wants to pay high fees to his lawyer for the other party's lawyers to learn on the job. Please don't imagine that it doesn't happen.

It is far better to pay top fees for a few hours of an expert's time than to save on the hourly rate but spend five times as long getting into legal and technical difficulties. Some firms offer 'packages' specifically targeted at the start-up and growth sector, which can be very good value as it implies that they really do know their business.

Get a quote for the whole job, and ensure that they stick to it.

Quite rightly lawyers won't act as honest brokers, but they can act for the company, as opposed to its shareholders management or directors. This means that the other parties involved can if they choose to obtain their own independent advice, and it will almost inevitably result in a cheaper overall deal cost.

10 RISK MANAGEMENT

In which we take a look at the assessing understanding and reducing the impact of risk before during and after doing a deal, and in building and managing portfolios to optimal cash exit.

10.1 RISK MANAGEMENT

The process of recognising, understanding, assessing and then developing strategies to cope with risk is known as risk management. Risk Management encompasses recognising what risks are relevant, assessing them as to how they might impact upon the situation, and developing courses of action to prevent or mitigate those impacts.

In general, the strategies to manage risk include

- avoiding the risk
- transferring the risk to another party,
- reducing the negative effect of the risk. This comes in two forms:
  - reducing the likelihood of occurrence
  - reducing the severity of impact should it happen.
- accepting some or all of the consequences of a particular risk.

Ideal use of these strategies may not be possible as some of them may involve unacceptable trade offs.

First, risk can be avoided. Fairly obviously, you do not have to accept any risk if you don't want to: just say 'no'! The only drawback with this approach is that if you do want to be involved with Business Angel investment, you will have to accept some level of risk, and if you just can't get comfortable with it then you need to accept that this type of investment is not for you.

Next you can try to transfer some or all of the risk to a third party. This is possibly the best way to cope: you may not be able to reduce the risk itself, but you can share it. Get others involved, in both decision making and funding. For 'unlikely but major' risks, you can often pay an insurer to take the risk from you.

Reducing the risk comes in two shapes: reducing the likelihood of occurrence, and reducing the severity should it happen. The fuller the Due Diligence and 'Reasonable Enquiries' you are able to conduct, the more you will discover and draw attention to risk factors and the less likely they are to happen. You may also be better positioned to put in place measures to reduce the severity of a factor. For example, you could amend or improve ambiguously worded agreements, or contracts that could be significantly abused.

Finally you might decide simply to accept the risk: it is either so imponderable or so unlikely to happen that you just resign yourself to taking it on the chin should it happen, or it is so trivial that it doesn't much matter anyway. This tactic is also more appropriate if you are going to be actively involved in the business, as then the identified risks are likely to be significantly reduced. Being more closely involved in decision making or day-to-day mentoring as an Angel investor reduces risk factors because the Angel has experience, and has dealt in the past with similar situations: he knows better what to look for and what to expect. We look more closely at how investors can try to influence management's success in optimising business performance later on.

External factors such as tax, exchange rates, the price of energy, or industrial action, to mention just a few, will affect performance; management's role is to minimise any negative impact, taking full advantage of helpful influences.

In all probability, few people actually care about the risks to a business per se: what they care about is what the management do about them, and the impact they have on the bottom line should they happen. This is where the concept of Uncertainty becomes invaluable. It is how the management deal with Risks that matters: how they minimise the Uncertainty, making projections more believable and results achievable.

10.1.1 RISK HOMEOSTASIS

Risk homeostasis implies that an individual has an inbuilt level of acceptable risk which feels comfortable, and this varies between individuals. When the level of risk in one part of the individual's life changes, this tends to mean that there will be a corresponding counterbalance in what and how much risk is acceptable elsewhere.

There are implications for management motivation. Many studies have shown that those who value the future more highly have lower accident rates and take fewer risks than those who discount the value of the future. They also find that there need to be direct incentives for people to behave in a more risk-aware way.

In particular, this carries implications for the relationship being built with the Principals during and after the deal process. Keeping motivation high is essential. The best practical approach seems to be 'much carrot, little bit of stick'. This thought should be borne in mind when negotiating a Deal.

10.2 DUE DILIGENCE

After negotiations have been completed, potential investors will want to satisfy themselves that they have properly and fully understood everything about the deal, that it is all as stated without any surprises, and what if any modifications to the Heads of Agreement might be necessary. They do this by checking everything out in Due Diligence and Enquiries. This should be done very thoroughly, and any weak arguments, evasive disclosures or attempts by the existing management to bluster or bully should be weighed carefully as significant warning signs. And don't allow the legal process to run up costs ahead of the due diligence, or it could be costs wasted.

With existing businesses, ask to see the company Memorandum and Articles of Association (do the principals know what you're talking about? Worry a little if not), and pay the nominal Companies House fees to access the on-line record. You can identify all existing shareholders, and quickly discover any peculiarities. Are there already lots of smaller shareholders? If there are it could be a big problem especially if your valuation means a substantial dilution. Are they, and the company, UK based?

Have a look at what and/or who you are thinking of investing in, as much to see if the principal knows what he's doing, or if he's trying to be sly or too clever. Be extra cautious when the company structure is really complicated or unstructured. Often it's not even covered. Don't confuse this with full Legal Due Diligence, done by lawyers later should you go ahead with the deal, it's just a sensible precaution, as so many people just assume or take as read what they're dealing with, and so often they're wrong.

The investor should assess all the Risks and Uncertainties by investigating the entrepreneur's claims and deciding how realistic they are. Do whatever checks into the business that are practical: its market, operations, resources, finances; call and meet key customers and suppliers; check into the product, technology and markets; ensure the IPR is owned by the investment vehicle, and check into everything you need to in order to get comfortable.

Perform detailed reviews of the forecasts with 'what if' scenarios, understand the true potential cash requirements, and especially challenge the assumptions made by management by performing sensitivity tests.

Most importantly, check into the People. Follow up their CVs' connections, not so much in a formal 'reference' sense, but chat to anyone to get a thorough feel for their competences and personalities. Consider their background and strength to achieve future objectives, and have a look at the existing or proposed management service contracts. Notice periods and remuneration packages can be especially revealing, and consider the level of incentivisation in place. Research the management's level of personal and financial commitment: if it all goes wrong, what do they stand to lose? What is the moral hazard?

Checking into any other directorships they might have or have had can also be very revealing. What went right, what went wrong…and if they still have any, why?

But it should not be all one sided. The entrepreneur should also be checking out the investor's credentials too. The investor will have made claims about his usefulness to the business, what he has to offer; accordingly, the entrepreneur should check everything out: his claims, history, contacts, money, liquidity, Business Angel experience, industry contacts and so forth should all be confirmed. Some people are not 'as it says on the tin'.

10.2.1 DUE DILIGENCE: ENQUIRY PARALYSIS

Also known as Paralysis by analysis: if risks and uncertainties aren't properly assessed and prioritized, time can be wasted in dealing with risk of losses that are not likely to occur. Of course, unlikely events do occur, but if the likelihood is low enough it may be better simply to ignore it, and deal with the result if the loss does in fact occur.

Putting too high a priority on the Risk Management process itself could keep an investor from ever reaching a decision. This is especially true in very early stage ventures, where there is any number of factors subject to diligent enquiry which aren't in practice usefully assessable. Decisions are then put off until the investor is happy with the risk management process – which he never really is, or at any rate will not be until after the window of opportunity has gone.

A suggestion to overcome this problem for enquiries and Due Diligence is for the investor to decide what would be deal breakers, and look for them in the hopes that they are not there. If the investor is just looking for a reason to say 'no', he shouldn't wait!

10.3 LIMITING DOWNSIDES IN THE DEAL

10.3.1 LIMITING DOWNSIDES IN THE DEAL: TRANSFER SOME OF THE RISK

Is there another source of risk reducing money available? In this context, risk reducing usually means the same as 'not mine'. Can the financial risk be shared with other investors, which also helps combat isolation risk? It's often not good to be isolated on a Board or as a minority shareholder. If you invest with others at least you have shared interests and multiple voices.

Are there any banks or finance houses that specialise, or who have funds that could be tapped into? Are there any Grants or Awards available? It may be worth using a specialist to explore these avenues, as the number and variety of sector, social, local, regional, national and EU Grants is daunting, and even when you know about them it can be very difficult and time consuming to access them.

Tax reliefs are usually available for early stage businesses (see the section on Tax Breaks for Business Angels), so if possible share the risk with the Inland Revenue. There are so many rules and regulations surrounding this subject, so always seek proper advice from a qualified specialist Tax Accountant.

10.3.2 LIMITING DOWNSIDES IN THE DEAL: REDUCE YOUR EXPOSURE

One way to have control over downside risk is to release cash only when the Business Plan demands it. Funding the business cash flow allows the investor to ensure that things are going to Plan. This works well enough if all is OK, but life is rarely as helpful as that. Being too prescriptive is going to be a recipe for continual arguments, or failure.

Performance milestone funding has similar potential difficulties. Investor and management agree between them what needs to be done by when by whom and how it's to be measured: specific, measurable, appropriate, realistic and timely. They ensure the reporting requirements are similarly specific so there's sufficient information to evaluate the risk of loss at every stage, and they also need to ensure that the rewards remain proportionate: things change. They need to keep track and allow for variations.

Investors need to mentor and support their investee businesses with a view to helping them make a profit. And not just make a profit for the business, but make you a real cash profit within an acceptable timeframe. Yes, we know that's what they said at the time of investment; funny how things sometimes change after the cheques have cleared….

Whether funding cash flow or milestones, investors must always be prepared to say 'no'.

10.4 APPLYING MODERN PORTFOLIO THEORY

Modern Portfolio Theory (MPT) was first developed by Harry Markowitz in 1952, and earnt him the Nobel Prize in 1990. While the theory has many practical problems, it is nonetheless very useful in principle and we propose a modification incorporating the investor's assessment of risk and reward, as we shall show below. But before going into the detail of our modification, let us first explain why the theory is in principle useful

Successful investing is a trade off between risk and expected return, and in general assets with higher expected returns are riskier. MPT is a theory of finance that uses mathematical models to maximise the expected return from a portfolio for a specified amount of portfolio risk, or equivalently minimise the risk for a given level of expected return. It does this by carefully choosing the proportions of various investments with the aim of selecting a collection of assets that has collectively lower risk than any individual investment.

This is done by taking into account the way in which the risk reward ratio of each investment relates to that of the overall portfolio, rather than simply choosing investments individually each on only its own merits. This is fundamental: the concept behind MPT is that the investments in a portfolio should not be selected solely individually, but rather according to how each relates to every other investment in the portfolio.

This is in stark contrast to the way some Business Angels make investment decisions: they try to 'pick winners' in order to maximise rewards. So, in an extreme example, if one particular sector shows promise an investor would pick all of his portfolio from the same sector. But 'picking winners' as a strategy simply can not win, because there are far too many variables and unknowns in the market. Investments that today seem like they might be spectacular winners turn out to be turkeys, while the run-of-the-mill become stars. Although this is intuitively obvious, Modern Portfolio Theory was the first to prove it mathematically.

Simply put, the theory emphasizes on the importance of diversifying to reduce risk. With optimum diversification, the risk weight of a portfolio is less than the average risk weights of the securities: diversification eliminates non-systematic risk.

All of this is fine until it comes to actually applying it to the world of Business Angel investment. Markowitz's theory assumes, among several other things, rational investors with liquid investments in a perfectly efficient market. This is very obviously inappropriate for highly illiquid Business Angel investments.

The theory also assumes that investment performance follows a 'normal' distribution pattern, the standard 'bell curve' of statisticians. The distribution of many things in nature does apparently follow a 'normal' distribution astonishingly closely. The heights of individuals, the populations of cities, the sizes of deserts… the distributions of so many naturally occurring phenomena follow the same pattern. But not all. The occurrence of some things follows a power law: forest fires and earthquakes have no theoretical upper limit, but bigger ones are rarer then smaller ones and biggest ones rarer still.

And as Nassim Nicholas Taleb has shown in his book The Black Swan, stock markets are similar. The distribution of the performances of stocks and shares is not 'normal', so any model that assumes that it is will fail. That this is untrue was graphically demonstrated in Black September when automatic computer trading, applying MPT, crashed the markets. Large swings occur in the market far more frequently than normal distribution predicts. Indeed, we would argue that Business Angel investment is even more highly asymmetric. The absolute downside is limited to the sum invested, whereas the upsides can be tenfold, twenty fold, or even the rare but spectacular thousand fold: they are potentially limitless.

And finally, in contrast to the 'perfect investor' of MPT, research in the field of behavioural economics shows that all investors do not necessarily act rationally or are risk-averse. In reality people are people and are neither always rational nor consistently rational. They behave emotionally, and take decisions despite their assessment of risk just because they have a good gut feeling.

Applying these thoughts to Business Angel investing, investors should first of all familiarise themselves with the various valuation models and with use of the risk-reward model we describe, and get sufficiently comfortable with making the 'risk' assessments to form a personal benchmark as to what scores mean what, and how they can be more objectively useful.

The investor then has to decide on his personal risk-reward profile. This is not as daft as it sounds. A balanced portfolio will contain investments with a range of risks and potential rewards. Investors need to decide what return will satisfy their requirements, and construct accordingly. Investors should take on increased risk only if compensated by even higher expected returns, and conversely investors who want higher returns must accept more individual risk. The exact trade-off will differ for each investor, but as a rule if you choose to invest in opportunities with increased risk, you must increase the unit reward per investment and increase the number of investments.

As well as needing to work out the best balance of investments across a Business Angel portfolio, the chance of making a killing can be worked out; if you don't want to know about the sums, feel free to skip the next paragraph.

Taking the Risk Reward Ratio 'R/r', the Ratio of each individual investment 'I' can be written thus: for I_1, R_1/r_1; for I_2, R_2/r_2, and for I_3, R_3/r_3, etc. The probability P_1 of I_1 being a success is $1/r_1$ and so on. So with n investments, the chance of finding one winner is

$$P_n = (1-1/r_1)*(1-1/r_2)*(1-1/r_3)\ldots\ldots*(1-1/r_n),$$

and the Return from the winner will be

$$Return_1 = P_n*R_n$$

the chance of finding two successes is

$$P_n* P_{(n-1)}$$

and the Return from two successes will be

$$Return_2 = (P_n*R_n)+ (P_{(n-1)}*R_{(n-1)})$$

while the chance of n successes is

$$P_n * P_{(n-1)} * P_{(n-2)} * P_{(n-3)} \ldots\ldots * P_1$$

(Which, frankly, is going to be infinitesimal well before you get to P_1).
The overall reward from this portfolio will be

$$\sum \text{Return}_{(n=1)}^{(n=n)}$$

So, in order to achieve a satisfactory portfolio, the investor needs to work out how each new investment contributes to his portfolio until the time when his risk-reward requirements are satisfied.

In order to have a better than 75% chance of finding a winner, an Angel must make about 35% more investments than the risk he will accept. So if he is happy with ten investments (pretty much a minimum) he will need to have a risk profile of one-in-seven; with twelve investments, a risk profile of one-in-nine; or conversely with a risk profile of one-in-twelve he will need sixteen investments. Other numbers for different investor risk profiles are given in the following table:

Acceptable risk profile	Number of investments needed for chance of overall profits:		
	75% chance	85% chance	95% chance
one-in-6	8	11	16
one-in-8	11	15	22
one-in-10	13	19	28
one-in-11	15	21	31
one-in-12	16	23	34
one-in-15	20	29	
one-in-16	22	30	
one-in-20	27	37	
one-in-25	34		
one-in-30	41		

It is readily seen that a near-guaranteed successful portfolio comprising only very high risk investments is impractically large, as in reality it could not be built and managed by any one individual.

But it is not as simple as that, as with more investments the chance of finding more than one winner also increases: it is more likely that an investor will find two winners in a large portfolio than one winner in a smaller (but still diversified) portfolio. And this substantially increases the attraction of increasing the risk profile as shown:

Acceptable risk profile	**With a 3-to-1 Reward to Risk ratio,**	
	Number of investments	**75% chance of making return of:**
one-in-6	8	3.5-fold
one-in-8	11	3.2-fold
one-in-10	13	2.7-fold
one-in-11	15	2.7-fold
one-in-12	16	2.5-fold
one-in-15	20	2.6-fold
one-in-16	22	2.6-fold
one-in-20	27	2.7-fold
one-in-25	34	3.1-fold
one-in-30	41	5.4-fold

The trouble with these analyses is, of course, that we are comparing like for like returns, and while the returns on 'one-in-twenty' risks can be very high, you might spend a lifetime looking for just one 'one-in-six' risk deal with a similar return. The table is purely to illustrate the point that the more investments that are made the higher the overall return will be, and not for practical guidance.

And another trouble is that no two individual investments will have the same risk or risk-reward ratio, so the investor will need to factor in the risk-reward weighting of each investment to get a balanced portfolio. This easier than it initially appears because it will take several months or even years in the making, so on-course adjustments become both necessary in light of actual experience and easy to achieve, again so long as the investor sticks with his strategy.

Another way of thinking about this is to consider the effects of Risk homeostasis on the risk appetite of the investor. So long as he makes enough investments, one would expect that his internal tendency would encourage a natural balance in his portfolio. Applying MPT allows a quantitative expression of an otherwise qualitative feeling.

And, it must be stressed, even an optimally constructed portfolio of Business Angel investments is not guaranteed to win. A good portfolio is far more likely to win, and win more, than a poor one; but there is always a small but finite risk of total loss.

10.5 PORTFOLIO MANAGEMENT

At the level of each individual business, identifying and quantifying the Uncertainties gives both investor and management information about the factors most likely to be amenable to influence, and where efforts are most likely to give optimal returns.

But before putting in any effort at all, and assuming that either money, or time, or both is a limiting factor, it is important to evaluate how much of what should be invested where.

Decision Theory and Game Theory have implications for Business Angel portfolio mentoring and funding. It seems reasonable to assume that in any highly complex situation, such as the management of a Business Angel investment portfolio, the outcome will be highly variable. It will be influenced by numerous factors, many of which will be out of the control of both principals and investors. All they can do is react in the best way, for them.

But there will be some factors within the influence of both investors and management. Certainly one of these will be the time spent in mentoring, another will be whether or not to make additional funding available and on what terms.

10.5.1 PORTFOLIO MANAGEMENT: LAW OF DIMINISHING RETURNS

It is intuitive that if no further money for the unexpected is invested, or no extra time in mentoring is spent, some businesses in the portfolio will fail that might otherwise have been successful. So doing nothing by way of investment or mentoring is not the most profitable behaviour.

Similarly, no matter how much time money and effort is expended, there will still be some businesses that fail for reasons beyond control. So doing 'everything' is also not an optimal solution.

Game Theory tells us that there will be solutions to the problem that give maximum returns for minimum additional investment of money or time or both. (But it's worth noting that as Game theory also struggles to analyse anything much more complex than 'noughts and crosses', we are not going to make any substantial claims here beyond finding general pointers to the right approach)

10.5.2 PORTFOLIO MANAGEMENT: FINDING THE OPTIMAL SOLUTION

Just observe that even in theory throwing time and money at investee companies will not produce optimal results, and as a consequence the smart investor should be able to manage his portfolio without breaking into too much of a sweat. All (!) he has to do is to put the right time effort and money into the right companies at the right time.

There is a host of external influences impacting upon the outcome, some of which will have unexpected and unpredictable trigger effects, much like the classic flap of the butterfly's wings. Creating a quantitative model that always works is quite impossible. The best that can be done is to put down a couple of general qualitative guidelines for experienced investors to add to their judgment at each decision point for each company:

- Maximise overall returns for any given effort
- Minimise financial risk to prevent losing good money after bad
- Minimise time to exit

When there's limited money and so many hours a day, how does one decide where to spend what?

10.5.3.1 Portfolio Management: Mentoring: Constraint Theory

This is not an attempt to 'teach grandmothers to suck eggs'. The traditional sources of Business Mentoring have plenty of assistance available for those that need it, the investor who has got this far probably doesn't need it anyway, and besides it's not our bag and we wouldn't presume. However, the topic is important because the availability or otherwise of business mentoring can be one of the major constraints on success.

The more time and help an investor gives to his protégé companies, the more likely they are to succeed. But a person only has so many hours in a day, and most Business Angels get involved as Business Angels to make money whilst having fun, not to have heart attacks. So what devices are there to help allocate the precious resource of an investor's time?

One obvious answer is to give more attention to those that shout loudest. This can be the easiest option, but it is not the most profitable.

The answer for those who like 'consulting' is to give more attention to those in most need; this is also very tempting emotionally. It satisfies at both levels: doing something where superficially most needed, and carrying the promise of greatest personal reward if successful. But again, is it the most profitable?

Besides, who is to predict that a very profitable investment that is consequently left alone couldn't become staggeringly successful for the want of a little – possibly unrequested – attention?

Unfortunately, productive mentoring is not the only call upon an investor's precious time. Should things start going wrong, relationship difficulties frequently arise between the investor and the principals. Differing views on strategic goals, exiting, further funding, resource allocation and so forth are a fertile ground for dispute, and this can be the most demanding of all constraints on time.

And when this happens, cutting and running may not release time without considerable financial cost. There is no chance of the principals paying top dollar to buy out a minority investor with whom they are in dispute; indeed, getting anything at all might be seen as a good result.

In the context of making decisions about resource allocation, all these considerations must be weighted and factored in.

The approach that we promote is to give more attention to those that hold promise of greatest cash reward for any given input of money and or of effort.

In a perfect world and with the benefits of hindsight, we would cut out all those that are going to lose money anyway; we would give effortless moral support to all those that are going to make money anyway; and we would concentrate all our energies and resources only on those in the middle. If only we knew which was which!

To help with this, we take a quick tour of all the Risk factors, how their impact on the business can be modified by management, how management can reduce the uncertainties, and if management performance in any area is amenable to mentoring intervention.

People, Model, Vision, Stage and Motivation: which of these risk factors is realistically amenable to risk reduction through further investment and/or mentoring, so minimising business Uncertainties and optimising business performance? Let's take a quick look at each in turn.

- **Vision Risk**: Was it too unrealistic, were there too many external unknowns? If you got this wrong, you'll be starting again from scratch. Maybe you'll do it, maybe not; but it will be a different deal, this one has gone.
- **Stage Risk**: it's difficult to see how this could be wrong, as it's the most objectively assessed risk factor. If we're talking about helping a business through a difficult stage, it's not 'Stage Risk', it's management, ie People Risk. If it's that things are taking longer or are more expensive than planned, the problem lies in Resource, ie Model Risk
- **Model Risk**: This is most likely to need attention, but it's not your job to do it other than indirectly through your role as Director, unless you want a job too. Let's take each Model Risk factor in turn:
  - **Finance Risk**: is there enough working capital? Is Capital expenditure under control? Or is cash flow an issue with debtors running away…this looks like a management issue, not a problem with the Financial Model.

- **Operation Risk**: is it meant to be running smoothly? Would investment in equipment or people improve things? Or is it a management issue….
- **Resource Risk**: is there enough room? IT? Bodies? Storage? Is there capacity to function at the right level? And so on; are the resources simply not there, which might need money; or is it that are they not being used properly?
- **Market Risk**: would – eg – extra advertising spend make a difference? Or would extra staff training be of more benefit?

Model Risks are not really amenable to time, more likely is that you'll be asked to fund it where it's creaking: essentially, reducing Model Risk takes money, not time. It's the management of the model that is time intensive, not the model per se.

- **People Risk**: Like so many things in life, it all boils down to people. Let's take each People Risk factor in turn:
  - **Character Risk**: Are they honest? Moonlighting for the competition? Likely to run off with the secretary? You're already in there with them, and you're not going to change anyone's character. But if you have any concerns, keeping a closer watch is an excellent way to reduce your exposure to risk. Do it yourself, or pay a trusted representative (accountant, consultant etc) to do it for you, but do it. It has to be done. It's not, in truth, mentoring, but it's still your time.
  - **Experience Risk**: with Capable management, this will inevitably improve with time. You can't buy experience, you have to go through things and learn from them to get it. Again, time spent with inexperienced management is an excellent investment, especially if it's provided by someone highly skilled and experienced. It's a way of fast-tracking the transfer of your experience to them; it really is copper-bottomed mentoring; and it's always worth thinking about the merits of buying this in.
  - **Capability Risk**: Capable management understand their business model and can make it happen. They reduce Uncertainty through competence. Your time won't have any impact upon someone's ability: either they've got it, or they haven't. Maybe a bit of coaching will help, but only if the ability to learn and adapt is already there: it's definitely worth an initial investment of time to find out. Hopefully, you've not invested in incapable management. If it turns out that you have, replace them. It will cost time and money, but if the model is worth saving it might save the business.

- **Knowledge Risk**: With Motivated management, this will quickly improve with time. On their technology they will know more than you do; on their business model they will probably know more than you; in fact in pretty much anything other than in matters of pure business they may know more. If there are any areas of knowledge that they lack, tell them to acquire them. This should be their time, not yours. Obviously, their time might also impact upon other resource availability and allocation in running the business, so there could well be short term time and money issues for you. But it's not mentoring.
- **Motivation Risk**: Are they enthusiastic or aren't they? Will your time be an effective substitute for an attractive bonus or share option? Or are they simply using you as an extra body?

Motivation is possibly the only Risk factor that can change – in a modest way – on a daily basis, and can be massively influenced by investor support or disinterest. Motivation Risk also has direct affect upon management performance: a highly motivated, committed and involved management will upgrade their Capability, Knowledge and Experience as positively and quickly as they can; demotivated management couldn't care less.

This might be a useful area to address and being supportive and available will help. It's a side benefit of mentoring rather than being directly amenable to mentoring per se: it doesn't intrinsically respond to mentoring, and given the perversity of human nature it might actually be counter productive if otherwise highly competent people are 'mentored' solely to improve their Motivation. Improving Motivation might cost you in terms of profit by giving them a bonus, or your percentage share by giving them share options, but as an investment decision it is a matter of whether the overall cake grows faster than your slice gets smaller.

In summary, distinguishing between Model Risk and People Risk can be difficult. Is it the Model that is creaking, or is it the People who are incapable of running it properly? Is it Resource, or Capability?

People Risk is the area of Business risk over which anyone can have realistic mentoring influence. All other risk factors derive from the day to day implementation of strategy by people, and how effective that is depends solely upon the people who do it. But if the plan is off-track, it will cost money to adjust the model, to recruit or train people to be more effective, or both. Is it worth it?

The specific variations in the assumptions whereby the plan has been taken off-track will be known: they are no longer future 'Uncertainties', but historical facts. You have to evaluate the impact of your attention on the management, and weigh this against the time you propose spend. You have to re-evaluate the financial assumptions and Uncertainties, and re-assess the potential risks. What is the potential payoff in terms of improvement in management performance (or reduction in management failure…) for each unit of your time? Ditto cash investment?

Finally, you relate this to the potential financial reward. What impact will any improvement of management performance have on valuation? What effect will putting in the extra funding have? How will they impact one on the other?

You need to work out what effect these inputs will have on any exit valuation. Are you likely to be able to profit from a third party sale? Or perhaps at least sell your shares back to management and so cut your losses? Or, as a last resort to stem losses, do you have to write off the investment and wind the company up?

You can make these decisions more easily by using the model. First, you enter into the model the new input assumptions about the various risk factors and Uncertainties whose assessments you have changed. The model will then produce a whole new set of projections, giving a new range of possibilities about where the company is going. This is not just the headline possible valuation from projected profits, but with the variations of uncertainty factored in.

Using both the target and the range of projected valuations, you will be in a better position to make sensible judgements about which options offer better probabilities of successful outcomes, and the ranges of spread of outcome. In other words, the same target exit valuation might be projected by each of two companies: one with a highly competent and motivated management team, the other with enthusiasts who've not done it before.

The first projection might be, for the sake of example, £5,000,000 +/- £1,000,000. The second might be £5,000,000 +/- £10,000,000. In these circumstances, the decision is easy – put money (if needed) into the first and time into the second: money into the second has to be contingent upon much tighter management. If only they could all be so obvious!

So in summary, and only where it happens to be needed and relevant,

Time reduces People Risk, but off-track investments will still cost money

Money reduces Model Risk, but who created the model, and will have to change their thinking?

10.5.3.1 Portfolio Management: Mentoring: Peer-to-Peer

For both entrepreneur and investor respectively there is yet another major benefit in being part of, or building, a portfolio.

It has always been known that an entrepreneur has a lonely life: he is leading from the front into new business areas with only his common sense and instincts for guidance. Only rarely does he have the assistance of any external support or guidance; at least with a Business Angel, he has a wise mentor. But there is far more available, and which arguably adds the most value.

The resource we are talking about is Peer-to-Peer mentoring. Clearly the businesses in the portfolio will each have their own Board and strategic objectives, and each will be at a different stage of development. Assuming the investor has chosen to work with high quality entrepreneurs, each will also be an extremely useful resource to the others.

Especially for early stage and business start-ups, Peer group mentoring provides valuable business, practical and personal support to entrepreneurs. It gives all entrepreneurs in the business portfolio access to a collective advisory board or think tank. The companies have faster access to information and benefit from the recent past experience of their peers; entrepreneurs get much needed cost-effective support at critical stages of their businesses. Under the supervision of the investor, they exchange ideas, share successes and challenges, and get feedback on personal and professional strategies. The group also promotes networking across the portfolio businesses, encouraging commercial synergies. Any lessons and good practices can be applied immediately, with the result that the performance of individual businesses and the whole investment portfolio derives considerable benefit.

Research indicates that both the benefits derived by a group member, and his willingness to mentor others in the future, are strongly related to the entrepreneur's satisfaction with the mentoring relationship. This implies that wise use of this tool generates a virtuous circle of growth and benefit for all involved.

The following guidelines help in setting up group peer mentoring:

- The membership of the Peer-to-Peer group should be specified in the shareholder agreement
- Expectations should be set at the outset, ensuring investor and entrepreneurs have a clear understanding of roles and responsibilities.
- The frequency and regularity of meetings should be specified and unbreakable. But don't make them too frequent; quarterly or so seems to work.

- Meetings should be reasonably structured and finish with a list of action points.
- Structured guides for discussions can ensure parties are on track, and can help avoid the less experienced feeling overwhelmed in their dealings with more experienced entrepreneurs.
- All members must agree to respect the contacts and networks of others and to follow up actions that involve others as agreed.
- Use external gurus to give input and inspiration; both costs and benefits are spread across all businesses.

10.5.4 PORTFOLIO MANAGEMENT: FURTHER FUNDING ROUNDS

In every successful business there is likely to be a cry for more money: it will be unable to take all the opportunities on offer with the resources available. Sales expansion, new technologies, research, new geographies, the list could go on and on. Second and further rounds of funding are almost inevitable, and unless the Angel investor is very lucky he will have no cash money to show for it and little practical influence over the terms. He will simply have to stay put, keeping as much of his holding as he can for a future exit. Dilution is always a serious consideration, irrespective of any existing agreement on anti-dilution. For example, are you really going to say ‘no’ to a take-it or leave-it offer to build the company for a flotation?

To help with this, let’s take a quick look at one tool which could be very useful.

10.5.4.1 Portfolio Management: Further Funding Rounds: Equity Fingerprinting, www.equityfingerprinting.co.uk

Equity Fingerprinting is a valuable and practical proprietary tool for looking at the evolution of a company’s structure as it grows. It gives a neat visual understanding of the effect on shareholders of raising funds through selling equity by combining size and share in one simple visual model.

Philip Baddeley and his team at Cambridge have done extensive work with the model, usefully analysing the growth patterns of dozens of companies. By seeing which pattern has historically had most benefit for a similar company to the target, it is easier to make decisions about how to grow, where and when to turn for funding, and how to optimise founder shareholder value.

An Equity Fingerprint is a unique method of graphically communicating the equity evolution of a company, encapsulating the equity structure and valuation. It is essentially an equity map, individual to each business. The business is represented by a circle called the Equity Wheel. The size of the Equity Wheel grows and decreases in relation to the value of the business. The Equity Wheel is split into sections, each of which represents the percentage of the business owned by each shareholder.

While the Equity Fingerprint shows very graphically what is happening to an investor's share value, the same story can be told in other ways.

We can start with an entrepreneur who has created something of value. For the sake of argument let us call it intellectual property that justifies a valuation of £100,000. Note this is not what it has cost the entrepreneur to create, it is not 'sweat equity', it is what an independent arbiter might judge it to be worth, or at least the value agreed for a deal. The Principal then sells 30% of the business to one or several Business Angel investors in return for funding of £200,000.

Note that although £200k has been invested this does not necessarily value the company at £100k plus £200k, as nothing has happened other than an input of cash, without which nothing would still happen. The principal owns 70% for his initial valuation of £100k, valuing the company post investment at £145k in round figures. In all probability the £200k funds will be invested as £45k equity and £155k debt.

If the business then grows successfully for a while the cake just gets bigger, say to £3,000,000. Interestingly, Equity Fingerprinting found that where the risk is split between several angels, later valuations tend to be higher.

At this point, they need a significant injection of capital to achieve their goals and manage to persuade one or more Venture Capital houses to put in £2,000,000 for a 40% share. Note that both entrepreneur and Business Angels have been diluted, and that as this time the investment is all in shares the post investment value immediately grows to £5m.

And they then go on to make a successful exit for £25,000,000 a few years later.

It's not the percentage share of a company that is owned that's as important as the value of the share. So long as it keeps on getting proportionately bigger, the shareholder is getting richer, on paper at any rate as shown below:

	£ value	Principal share & £ worth	Investor share & £ worth	VC share & £ worth
starts with IP	100k	100% 100k		
raises £200k for 30%	145k	70% 100k	30% 45k + 155k debt	
grows to £3m	3m	70% 2.1m	30% 900k + 155k debt	
raises £2m VC money for 40%	5m	42% 2.1m	18% 900k + 155k debt	40% 2m
grows to £25m sale	25m	42% 10.5m	18% 4.5m + 155k debt	40% 10m

Using a technique such as this helps focus on the change management within a business. It helps shareholders decide when they should accept dilution of their share in the company in order to gain the resources needed to make the company grow, and how the company changes to accommodate this. These points are change nodes. Each decision point in the company funding history is a node, and the effects of the decisions made are seen in the changing size and structure of the company.

The decisions made at certain points within the company's life will determine its future growth, its value and its ability to survive. Getting the quanta and timing of decisions right can be of major benefit for the dilution of the founders; getting them wrong could jeopardise the whole business.

The job of investors is to optimise the size-share balance, to end up with most cash profit at the exit.

10.6 EXIT CONSIDERATIONS

They say it's never wrong to take a profit, so if you find yourself having to decide whether or not to accept it shouldn't be a difficult decision. You might wonder if by exiting too early you will be missing out on a future liquidity event, but without considerable planning and an experienced Board it's better to take the money.

There are really only two possible exits: it boils down to private sale or public flotation.

Public flotations are sometimes called Initial Public Offerings (IPOs), and are considered to generate a higher price for the Company and allow the exiting management to remain in place to maximise their value from the business. The major issue with IPOs is whether or not the business size justifies the cost, which is very expensive. By the time lawyers and nominated advisers have been appointed, and investment bankers sought to underwrite the issue, the costs involved can be justified only by significantly large businesses.

Besides high legal, accounting and marketing costs, there are several other practical disadvantages to completing an IPO:

- Much time, effort and attention is required of senior management, who will thereby pay less attention to actually running the business
- There is always a risk that required funding will not be raised, incurring either underwriting fees or wasted costs
- There is compulsory public disclosure of potentially sensitive information which may be useful to competitors, suppliers and customers.

Even to consider an IPO, the business has to develop an impressive management and professional team and for months or years beforehand groom the company's business with an eye to the public marketplace. It must obtain audited or auditable financial statements using IPO-accepted accounting principles, it has to prepare itself for forensic disclosure requirements, establish anti takeover defences, and develop good corporate governance. After all that, the timing of a public placement must take advantage of IPO windows which can be a hit-or-miss affair through no fault of the company, meaning that sometimes flotations are pulled even after incurring the costs.

There are many similarities with a private trade sale, in that to maximise shareholder value a considerable amount of work has to be done over a long time. But at least all the regulatory and reporting requirements of an IPO are irrelevant in a sale to a third party, which usually makes a private sale far simpler and cheaper.

10.6.1 EXIT CONSIDERATIONS: PAPER

Note that earlier we said 'cash profit'. Anyone with a bit of luck can make paper profits: we are ultimately not interested in paper, especially paper in an unquoted company. Unless it's a traded stock in a quoted company on a liquid exchange, and you have no buy or sell restrictions, it doesn't count as cash. The crunch comes in getting your cash back, with growth.

As an exit consideration, 'Paper' means that instead of, or as well as, cash at an exit the purchaser offers shares in the acquiring company. That may well be fine if it's a nice fat FTSE-100 company, but It basically boils down to one thing: would you choose to invest the cash equivalent of the share value in the acquiring business? What is your Risk-Reward?

One additional Risk factor to consider when offered paper is the possibility that you might not get another chance to get an exit. At one level, at least the new shares might keep alive your hopes of ultimately converting to cash.

10.6.2 EXIT CONSIDERATIONS: CONTINUING INVOLVEMENT / EARN OUT

It is usual when a larger business buys out a smaller one that part, often a large part, of the payment will be deferred and dependant upon future performance: an Earn Out. There will be a clause in the sale agreement that the management have to stay for a specified time, either still as employees or in a consultancy role, to ensure the smooth transfer of the business to its new owners. The arrangement also helps ensure that the purchaser does not overpay for promises, as all previous promises actually have to be delivered in order to trigger the deferred part of the payment. This type of arrangement shouldn't be an issue for Angel investors, who would normally be no more involved than as a Non-Executive Director and occasional Business Mentor. It's Key People who tend to be contracted to stay on to run or transfer the business after an exit, and after some years' involvement in an investee company, a Business Angel couldn't possibly be unaware that he's getting himself into that position.

Just make sure that as an Angel you get the same deal as the rest: that is why you insisted on a Drag and Tag clause in the Shareholders' Agreement.

That's it: good luck.

POSTSCRIPT 1

The author has made eighteen investments himself, and thought you might be interested to see what befell them.

9 have disappeared without trace
3 were exited with a less than total loss, and with much relief
1 is still struggling on, with no opportunity to exit
3 still show significant promise, but it's overdue that they did more than just promise it
1 is paying dividends
1 paid for itself several times over

Which overall is about what you'd expect

ACKNOWLEDGMENTS

An innumerable number of people have wittingly or unwittingly helped contribute to this book. Certainly each of the hundreds of Business Angels and thousands of Entrepreneurs I have met over the years has said or done something noteworthy.

So limiting my thanks to those who contributed directly to the Investment Workshops is justifiable only for two reasons: it would take too long, and anyway be impossible, to name each of the many individually; and those who helped with the workshops did so consciously and deliberately. My especial thanks go Chris Scanlon of UKBA, Steve Downing of Henley Business School, David Beer, founder of Beer & Partners and sadly missed, Neville Walker of ipConsult, John Snead formerly of Grant Thornton, Adam Dowdney of Shoosmiths, Leo Dunne of Arelldee Associates, William Owen, Barney Quinn, Sid Gould and Robert Jenkins, Business Angels, Paul Delahunty of Helvetia Associates and last but by no means least Paul Coleman, formerly of Finance South East.