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Raising Business Finance for Entrepreneurs Part I

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INTRODUCTION

Can money be made through Business Angel investing? Yes, and lots of it.

Can money be raised from Business Angels? Yes, and lots of it.

But neither is easy. Some Business Angels lose money and most entrepreneurs fail to raise their funding. This book is about how to invest successfully as a Business Angel, and how to raise funds successfully from Business Angels. It introduces a novel method to recognise, understand, assess and reduce the risks associated with Business Angel investing for both investors and entrepreneurs, and how to assess and maximise rewards. It shows how understanding this approach dramatically improves the chances of success. And finally it provides a practical model that really helps individuals do all the above.

It is interesting to think through the benefits both to the community and to the larger economy of increasing successful Business Angel activity. Consider if there were 200 new Business Angels each year, of whom enough invest to make up £10m additional funds invested each year. On a rolling 5-year basis, this would mean that an extra £50m or so of funds will be invested into, give or take, 200 new companies.

All this, in turn, will mean that as a consequence there is likely to be approximately 15 additional public companies created every 5 years, 35 extra trade sales, 100 extra administrations and liquidations (it's not nice to be involved in one, but statistically it's going to be about true, and it does keep one small sector of the economy going), 50 or so additional continuing businesses with varying degrees of success, 80 or so new high net worth entrepreneurs, many extra new mergers acquisitions and company sales, not to mention the on-going audit and compliance work for all these, and of course all the additional employment, new technologies and myriad other benefits.

Of course, no-one is going to be able to demonstrate cause and effect on this, especially after several years and multiple interventions from all kinds of sources. But it is nonetheless a truistic conclusion that without extra input, no extra funds would be available beyond those which the status quo would have produced anyway.

In the UK the Treasury and former Department for Trade and Industry have commissioned a lot of research into the factors that contribute towards Angel Investing and the macro economic impact that it has. But, perhaps in part because of the difficulties involved in researching an inherently private market, there has been surprisingly little done into the micro aspects of Business Angel behaviour: what makes it tick? What factors really influence investment decisions?

Studies in the United States showed that investors with portfolios of twelve or more Business Angel Investments were likely to beat the main stock market. It's all a matter of adopting the right strategy. Unfortunately, the same research found that those Angels who did not lose on their first Business Angel Investment, who were lucky enough to find a winner first time, tended to go on to lose most money overall. At this point, it is worth noting that personal private research showed that the average number of investments made by UK Business Angels was just under 2½, which is not at all encouraging as it probably means that three out of every four Business Angels will lose their money.

There is a large majority of 'Business Angels' who never actually invest at all, or who just lose money, certainly once, maybe twice and never come back for more, and can you blame them? And finding out about Business Angel Investment is difficult as there are very few sources.

The purpose of this book is to help more entrepreneurs find more investors who invest more money into more businesses, more wisely and – essentially – more successfully. It is targeted at a small but very important audience:

- potential Business Angels
- experienced Business Angels
- anyone wishing to gain an insight into what Business Angels are looking for, especially
- entrepreneurs and those who wish to raise money from Business Angels
- professionals, especially those acting in and around Business Angel activity
- and, finally, all those simply with an interest

It is intended to be a stand alone source of reference, a practical guide, and is based upon many years of direct personal experience, wise inputs from dozens of successful Business Angels, and follows writing and running a series of successful Business Angel Investment Workshops. There are two specific things that this book is not.

it is not a tax or legal handbook. What we try to do is point towards the many advantages to be gained from or alternative approaches to UK taxation and UK law. Please always obtain proper advice before making any commitments.

And most importantly. it is not a substitute for practical experience; even the most talented and successful businessmen can't simply click their fingers and instantly absorb the knowledge skills and experience needed to succeed out of thin air, they need to gain these from somewhere. And the Business Angel marketplace can provide a very expensive and unforgiving learning curve.

Anyone wishing to invest as a Business Angel needs a combination of four things, as well as enough spare money:

- success = skill + intelligence + knowledge + experience

To someone with even with the greatest skill, and intelligence, and the broadest knowledge, the book can not provide experience. Anyone wishing to put theory into practice would be well advised to follow some of the suggestions that follow in the relevant sections.

The book is divided into the following sections:

1. **Business Angel background**
2. **Thinking about Investing**
3. **The Approach**
4. **The Model**
5. **Uncertainty**
6. **Assessing Risk**
7. **Assessing Reward**
8. **Getting Funded**
9. **Doing a Deal**
10. **Risk Management: including**
    Portfolio Building
    Due Diligence
    Portfolio Management
    Exit Management

The reason for being involved in entrepreneurial or Business Angel activity is, fundamentally, to make money. Each section of the book focuses on a different aspect of the process, hopefully facilitating all those with any interest at all to make a success of it no matter what their wealth or background.

Each section is written in the style of a manual to address one aspect of the market and process of Business Angel activity, and inevitably with such a style the target audience changes from section to section. This is certainly not intended to confuse as we change the use of 'you' and 'they' throughout, each hopefully very obvious from the context. We strongly suggest that both investor and entrepreneur should read all sections, even – especially? – those that are not addressed directly to them.

'Business Angel background' describes some broader aspects of Business Angel activity: why there is any demand in the first place, who does it and what motivates them.

'Thinking about investing', is also intended for a general audience. It provides an introduction to the world of Business Angel investing, the associated regulatory background, what fiscal inducements are on offer for the investor, and what approaches give the best likelihood of succeeding both in pitching to it and in making money from it. Hopefully, it enables some of those who might never otherwise have given it a thought to think about it. Maybe, after all, such investments might make useful contributions to both portfolio and lifestyle.

The whole rationale behind successful business activity, including investment in it, is in making better judgments about Risk and Reward: more reward for less risk. No-one would ever get it all right, but everyone who can be more right than wrong will make money. So the next sections explain our 'Approach' to Risk and Reward, and introduce a practical 'Model' for use in Business Angel situations, where there are rarely such luxuries as track record, profits history or even balance sheets to help.

'The Model' explains how a structured approach to Risk assessment and management enables entrepreneur and investor alike not only to ensure that Reward outweighs Risk of loss, but to manage time and money to optimise outcomes from disparate inputs. The model is a multi-stage process, inevitable in a complex system such as business. The novelty in the model arises from the use of 'Uncertainty' and the way the 'Risk' quantities are interpreted and balanced against 'Reward'.

We then explain what we mean by the notion of 'Uncertainty', which helps in these assessments by formalising the process of allowing for margin of error. We show how it can be applied both to business valuations and to risk management.

'Assessing Risk', the next section, is designed more specifically to help potential investors and to give entrepreneurs insight. We go into the unique analytical model in more detail, through which judgments can be made on each of the several main factors that influence investment decisions. In particular, it helps investors assess the many contributing factors quantitatively, and so provides a more 'objective' decision making process – both for individual investment decisions, and for portfolio building.

The section on 'Reward' is essentially about how early stage businesses can usefully be valued, offering a number of alternative approaches. We show how using 'Uncertainty' in the assumptions used to calculate predicted values is enormously helpful in the process of arriving at a doable deal.

Armed with the necessary theory, the next section Getting Funded is designed to help all those trying to impress Business Angels with their business plans. In nature, all successful hunters are expert in understanding the habits and lifestyles of their target prey, whilst inexperienced hunters rush about seemingly randomly and often as not frighten away their prey long before they are within reach. For entrepreneurs seeking Business Angel funding, it is obvious which approach is more likely to be successful.

The section 'Doing a Deal' describes the processes and pitfalls that surround the entrepreneur and Business Angel actually agreeing terms and doing the deal. Hopefully some of the thoughts and suggestions will help smooth the process by signalling the many potential problems that can arise for the unwary.

We then show how the model can be used in 'Risk Management', 'Due Diligence', 'Portfolio Management' and 'Exits'. The approach could probably be useful in many business decisions, but here we aim specifically at Business Angel investments, and use the risk analysis model to help both investors and entrepreneurs make informed decisions about portfolio investments.

A quick mention must be made of Crowdfunding. Because this book is focussed on traditional Business Angel investing, the web based phenomenon of crowdfunding is not mentioned. For Business Angels, as opposed to smaller investors wishing to back exciting opportunities, this is not an omission as crowdfunding satisfies only a small part of a Business Angel's requirements. For entrepreneurs seeking money, that is not necessarily the case. Funding in the form of equity or loans can be sourced through any number of crowdfunding websites; what can't be found there is a Business Angel mentor.

1 BUSINESS ANGEL BACKGROUND

In which we take a general overview of Business Angel activity:

1.1 Why do Business Angel opportunities exist in the first place?
1.2 Who are Business Angels?
1.3 Why do Business Angels make such investments?
1.4 What kind of businesses do Business Angels invest in?

1.1 WHY DO BUSINESS ANGEL OPPORTUNITIES EXIST IN THE FIRST PLACE?

Business Angels are investors in usually small unquoted companies with very high growth potential. But why are the opportunities there at all? If the rewards were attractive enough, surely established sources of money would be competing to invest instead? The answer lies in part in the cost of doing relatively small investments. There are good reasons that larger institutions can't afford to take the risk, while individuals can.

And there are several aspects to this. Firstly, Business Angels must be capable of having their money tied up for years. Of the businesses that need Business Angel funding, even with the best will in the world the biggest potential winners are unlikely to provide the investor with any cash returns for some years. Institutional money comes from institutions. That is hardly surprising, but it means is that there is a hierarchy of employees, all earning wages and needing cash flow to pay them. So even small institutions have great difficulty in absorbing the cash flow requirements of small scale investing, whereas an individual with independent income has no such concerns.

A second major reason is the cost of doing the deal. An individual with independent income can take whatever time he likes to find deals, make sure they are what he is looking for and that there are no unacceptable hidden frights lying in wait ("Due Diligence"), and negotiate terms. He can probably do most of the work himself at no or little actual cost. Institutions, on the other hand, do not have this luxury. They have to pay everyone all the time. They are also responsible to their owners, the shareholders, so they can not afford to cut corners or take uncalculated risks. Effectively, this means that there is a minimum real cost for every deal that they do, and in order to achieve an acceptable return this cost has to be factored in. Which inevitably means that there is a minimum and relatively high economic deal size.

A third reason also involves the cost of deals, this time the cost of supervision. An individual is answerable only to himself for his time, whereas the institution's employees have to justify how they spend theirs. Supervising a portfolio of investments is time consuming, so again economies of scale are important and the institutions will focus on larger deals.

There are doubtless other factors too, but these three on their own are persuasive. And even if some Venture Capital houses feel aggrieved by this analysis, they will be so few in number that their combined investment capacity won't do more than scratch the surface of potential demand.

All this means that that there is an 'equity gap' for risk finance between what can be provided by High Street banks and what City institutions can do: from say a few £10,000s through to £2.5m, give or take.

Banks and other asset lenders such as factors do not risk their money, or at least not with small start ups. They avoid risk businesses even though they demand security as collateral: they are not in the pawn broking business, and will only lend on realisable income streams, and then only with security. They rent out their money, and they will want all of it back. The rent they charge, the cost of this money, is the interest rate, and is usually reasonably modest. This is in itself indicative of the bank's own assessment of the risk it believes it is taking. So the key to getting a bank's attention is to present a plan that is not going to cost anyone their job: it must look safe, thorough and generate enough cash to pay their interest, and give a near-guarantee of being repaid in a shortish timescale. Small high potential businesses without track record or balance sheet are simply not going to get bank money.

Whereas equity investors such as Business Angels usually expect neither interest nor their money back. To be fair, of course they want to make lots of money; but it's not quite the same money because they don't lend their money, they sell it. It is called equity money, and it buys a share in the business. And equity money is very expensive. Just think what you could buy for, say, £150,000 or £200,000. So a Business Angel is going to want a lot in exchange. The trouble is that there usually isn't much on offer, except the entrepreneur and his commitment. So typically an entrepreneur seeking Business Angel money must be ready to part with a large part of his business in exchange, and recognising this is often a major hurdle for many budding entrepreneurs.

1.2 WHO ARE BUSINESS ANGELS?

It is estimated that there are around 20,000 Business Angels in the UK, of whom 90% are male, aged 50 plus, with entrepreneurial or senior company officer background. Every year they invest some £800m to £1bn in aggregate, with individual deals ranging from £2,500 to £150,000, occasionally much larger: £500,000 is very uncommon but not unheard of. Of the funds invested, about 10% originates from Business Angel networks while the balance comes from 'Friends and Families'. But there is great difficulty in claiming any authority on these figures, as the main source of figures is Inland Revenue feedback on those claiming tax relief; but the rules for such relief rule out any family involvement. Besides, most Business Angels share a desire for anonymity and are unwilling to divulge information about their investment activities, while most Angel Networks will want to stress their size and success. Thus all estimates about the true and potential size of the UK Business Angel market are based on informed guesswork.

In the United States, Business Angels fund 30 to 40 times as many ventures as institutions and are by far the most important source of funds for entrepreneurs. There, groups of Business Angels tend to team up for both formal and informal collaboration, and these collaborations are better at filling the funding gap than are Angels on their own. Informal statistics suggest that there are some ten times as many Business Angels per head of population in the US than in the UK. Clearly there are cultural differences that explain some of this gap, but that doesn't explain why the US seems to have so many more good investment opportunities. And, frankly, the qualitative difference is illusory: there aren't more or better reasons in the US than in the UK. There are opportunities everywhere for those looking in the right way in the right places.

To explore where these might be, it is helpful first to look at what motivates a Business Angel? Why do it at all? The rewards must be greater than the risk, or no-one would make any such investments. A good place to start is to look at what traditional, non Business Angel, investors are looking for in order to establish what differentiates them.

Most investors typically want their money to work as hard as possible for them. There are as many reasons for wanting this is as there are people, but a fair assumption is that many want both current and future income so they themselves do not have to work, possibly not work at all and definitely work less hard. To do this, their income from investing has to be enough to replace what they get by working, to be enough for them to live on in whole or in part, without putting their lifestyle at risk. This implies that they want a secure income, and if they unlucky enough to have to cope with inflation for any length of time then they have to have a growing income too. A well advised investor is likely to have a mixed portfolio including cash for emergencies, bonds for income and equities for both income and growth, with a wide spread for security against the loss of any one investment. And all of this seems like a good idea, if it is attainable.

So why do Business Angels take the perceived extra risks? What are they looking for that is different? For a start, if the risk management is right, the perceived investment risks can be little more than illusions and the rewards significantly exceed the risks. An important caveat here is that even with a perfectly managed risk strategy, Business Angel investing is illiquid. The cash returns are slow to come, and a Business Angel has to be financially strong and independent enough to be able to comfortably afford to tie his money up for a long time or, in the worst case scenario, absorb a loss.

1.3 WHY DO BUSINESS ANGELS MAKE SUCH INVESTMENTS?

Terence Kealey once made the point that entrepreneurs (and by extension Business Angel investors) are rational, and if they find wealth easier to steal than to create, then they will steal it. We have often in the past made a similar point to aspiring entrepreneurs: for the money they seek from an investor, the investor could, if he were so minded, just as easily take the idea himself and make a very decent business out of it. And the entrepreneur couldn't really stop him, signed Confidentiality Agreements or not: with what money will the entrepreneur take legal action against anyone?

This in fact hardly ever happens. Why not?

Investors tend to feel 'been there, done that': they have already in their business lives done all the hard work, possibly several times. While most will still be able and prepared to roll up their sleeves and get stuck in, the investor is actually more interested in business strategy and growth. Rather than 'entrepreneurship', think of 'grandparentrepreneurship'. The investor will advise, mentor, help in any way that he can, and then disappear for a week while the management get on with actually doing the job. He wants to get the results of his 30% share of each of a dozen or more able entrepreneurs, without having to break into a sweat himself. Nice work if you can get it!

More than that, almost without exception the Business Angel investor is looking specifically for more than just financial returns, he already has those from the rest of his wealth. He wants a varied involvement, for lifestyle and fun. Many want to be directly personally involved in the businesses they back. They are themselves experienced businessmen, often serial entrepreneurs, who can bring enormous benefits to any business in which they have an interest.

The next thing to note is that the Business Angel investor is not investing for income. He will already have enough to cover whatever his lifestyle requires, as Business Angel investing does not generally produce income in the short term. Over the longer term, however, a well structured Business Angel portfolio will generate excellent investment returns. Here, longer term means getting exits by selling his shares in invested businesses and re-cycling his Business Angel money, so there is a minimum of five years and probably ten years to wait; but thereafter a Business Angel ought to be able to expect a very profitable and often tax free cash flow. So the implication of this is that the cost of investing for a new Business Angel is the early lack of cash flow, of keeping their money tied up. They should never tie up more than they can comfortable afford.

So a well managed Business Angel portfolio will provide generous returns both of money and of lifestyle, and on top of that there is often tax relief. A knowledgeable Business Angel, however, will not invest primarily for the attractive tax breaks, but he will consider all such tax advantages as part of his risk management. He effectively shares his risk with the Inland Revenue in order to make more investments over a wider spread of opportunities to reduce the overall portfolio risk. So to discover what it is that attracts their investment, we need to look at what makes a typically fundable business.

1.4 WHAT KIND OF BUSINESSES DO BUSINESS ANGELS INVEST IN?

Clearly no-one is going to invest in any opportunity that doesn't have considerable appeal and promise. It goes without saying that there clearly has to be a great business idea, but the mistake many so-called entrepreneurs make is to think that that is all that's needed. Far from it.

As the old mantra 'location, location, location', goes in the property business, so in Business Angel markets what is sought is 'management, management, management'. The investor does not want to run the business himself, he wants to invest in the entrepreneur's ability to make money. So the management will have to demonstrate a clear understanding of their chosen market; if relevant, a sound understanding of the appropriate technology; they must show massive amounts of motivation coupled with a strong work ethic; and such attributes as management skills, track record and sales charisma are definite plusses. These, however, can be learned, especially with the investor's help, if the management have the capability to learn and work with the investor as a team. So that's what the investor will be looking for.

But equally obviously all Business Angel opportunities also have inherent problems, or almost by definition they wouldn't be available as opportunities. Most commonly their considerable challenges will include too much to do, too little time to do it in, and too few resources on hand to do it with, especially sales, contacts, and networking. And the currency of 'resources' is, of course, cash: getting enough of it to enable them to buy in people and assets to address the shortfalls. There is likely to be a high awareness of these shortcomings, but little ability to change things by themselves. Creating and implementing a strong strategy will be lost among the day to day demands of getting going whilst underfunded. If there is a defined management structure, there will inevitably be gaps in it.

This brings us neatly to the conclusion of how Business Angels help: they fill these resource gaps. Entrepreneurs seeking money might also consider that if they find a perfect partner his contribution could perhaps reduce the sums of cash involved. They should have a clear idea of the non-financial attributes such as skills, contacts, sector experience and so forth that they would ideally like in an investor as well as how much money they need, and how much they want him to be involved.

Then they should go look for it.

2 THINKING ABOUT INVESTING

In which we explore in more detail some specific aspects of Business Angel activity and motivation:

2.1 Tax Breaks for Business Angels
2.2 Financial Services Act and Regulation
2.3 Timing of the Process
2.4 Business Angel Etiquette
2.5 How Much to Invest?
2.6 Portfolio Building
2.6.1 Investment returns
2.6.2 Portfolio spread
2.7 Collegiate Investing
2.8 Business Angel Networks
2.9 Deal Flow and other Related Matters
2.10 Personal Considerations about Investing
2.11 Summary
Crowd Funding

2.1 TAX BREAKS FOR BUSINESS ANGELS

It is not widely realised, but by far the largest contributor to Business Angel finding in the UK is the Inland Revenue. Over the years the British Government has tried to encourage enterprise creation and innovation by sharing the risks taken by Business Angel investors, in effect offering a form of matched funding through various tax breaks. Tax Reliefs are available in the right circumstances for Income Tax, for Capital Gains Tax and for Inheritance Tax.

A word of caveat: the rules surrounding the taxation of investment are very complex, and they do change. This is not an attempt to summarise them, even as they stand at the time of writing. It is more a quick overview of the sort of tax breaks which currently exist, largely lifted directly from the government's direct.gov website, http://www.hmrc.gov.uk/manuals/vcmmanual/index.htm. It is important to note that there are different rules for EIS Funds. There are also different rules for knowledge-intensive companies that carry out a significant amount of research, development or innovation, and either want to raise more than £12 million in the company's lifetime, or did not receive investment under a venture capital scheme within 7 years of their first commercial sale. Anyone wishing to get serious about Business Angel investing is strongly advised to consult a specialist.

Never take an investment decision because of Tax. Always make the investment decision on sound Risk-Reward investment principles, and having made the decision then and only then take everything that the Taxman has on offer.

There are three things that have to be just right for an investor to qualify for tax relief on his investment:

- The company has to be qualifying
- The investor has to be qualifying
- The type of investment has to be qualifying

and if all is in order, then the investor can qualify for Tax reliefs on income, Capital Gains and Inheritance. These do not all fall under the same schemes, but broadly have similar requirements.

In particular the Seed Enterprise Investment Scheme (SEIS) and Enterprise Investment Scheme (EIS) have been especially designed to help small, early-stage companies to raise equity finance by offering a range of tax reliefs to individual arms length investors who purchase new shares in those companies: Business Angels. These reliefs are available to investors under wide but strictly applied circumstances.

If an investors is to qualify for SEIS and EIS, the company which issues the shares has to meet a number of rules regarding the kind of company it is, the amount of money it can raise, how and when that money must be employed for the purposes of the trade, and the trading activities carried on. The Inland Revenue offers advice on whether or not a company is likely to qualify before the shares are issued, which is especially useful as it gives an opportunity to spot any problems before shares are issued, and the assurance can be useful to show to potential investors.

The company has to observe these rules at the time of the investment and for at least three years afterwards. If it fails to meet those rules tax relief will not be given or, if it has already been given, will be withdrawn.

Investors are not eligible for Income Tax relief on the cost of shares if they are or have been connected with the company in either of two ways. First is to have a financial interest in the company, or in any subsidiary of the company, by holding more than 30 per cent of the share capital or voting rights; and second if the investor or a family member or associate is a director (though see below) or an employee of the company, he is deemed to be connected with it and will not qualify to get these reliefs.

However there is an exception to the above restrictions for directors who are 'Business Angels'. They are not deemed to be connected if their only connection with the company was as a director who was not entitled to remuneration, and they had not previously been involved in carrying on the trade the company was carrying on at the time it issued the relevant shares.

All shares must be full risk ordinary shares and be paid up in full, in cash, when they are issued. One of the most common reasons for investments failing to qualify for tax relief is that shares are issued to investors without the company having received payment for them. This sometimes happens when a new company is registered at Companies House and shares are issued to members as part of the registration process, but the company then takes some time to set up a bank account and the shares are not paid for until that has happened.

There are many anti-avoidance provisions to ensure the investor is not protected from the normal risks associated with investing in shares on a proper arms length basis.

SEIS complements EIS and is intended to recognise the particular difficulties which very early stage companies face in attracting investment by offering income tax relief at an even higher rate than that offered by EIS. SEIS Income and Capital Gains Tax reliefs are otherwise similar to and modelled on those available for EIS.

SEIS Income Tax relief is available to individuals at 50 per cent of the cost of the shares, on a maximum annual investment of £100,000. Investors need not be UK resident. EIS relief is at 30 per cent of the cost of the shares up to a maximum of £1,000,000.

Capital Gains Tax reliefs come under four headings:

- CGT exemption: for investors with a qualifying investment, any gain is exempt from Capital Gains Tax
- Share loss relief: if qualifying shares are disposed of at a loss, investors can obtain income tax relief on the net amount of the loss
- Deferral relief: money invested in an EIS scheme under deferral relief can offset a previous Capital Gain
- Entrepreneur's relief may also be available in certain circumstances, and this too reduces the amount of the Capital Gains Tax on a disposal of qualifying business assets up to a lifetime limit of £10 million. The entrepreneur must hold at least 5% of the ordinary voting share capital, and must have met the qualifying conditions for a one-year qualifying period up to the date of disposal.

Inheritance Tax is not payable on qualifying unquoted Shares, including those listed on the Alternative Investment Market: one hundred percent tax relief is given provided the shares are held for a minimum of two years, the shares are in a genuine trading company, and the company assets are genuine business assets.

2.2 FINANCIAL SERVICES ACT AND REGULATION

The sale of, promotion of, management of and/or advising on any Financial product 'by way of business' is highly regulated in the UK by the Financial Conduct Authority (FCA).

On the whole, individual Business Angels making Business Angel Investments are unlikely to be caught by any regulatory issues. For example, an investor who negotiates directly with an investee company and makes his own investment decision without any external input is not affected, and does not need to be authorised by the FCA.

An individual Business Angel investor is entitled to receive business plans and make investments through his own decision, provided that he can prove he is certified as either a High Net worth Individual or a Sophisticated Investor. To comply with this the investor has to sign a certificate which declares that he qualifies as either a Certified high net worth individual or a Certified Sophisticated Investor.

A High Net Worth Individual must certify that he has a net income in excess of £100,000 per annum or net assets in excess of £250,000 excluding pension fund assets and private residence.

An investor qualifies as Sophisticated in any of the following cases, and must certify that either: he is a member of a network or syndicate of business angels and has been so for at least the last six months prior to certification date; or he has made more than one investment in an unlisted company in the two years prior to certification date; or he is working, or has worked in the two years prior to certification date, in a professional capacity in the private equity sector, or in the provision of finance for small and medium enterprises; or he is currently, or has been in the two years prior to certification date, a director of a company with an annual turnover of at least £1 million.

But it is not all good news. The certificate must make it clear that the potential Investor understands that he may receive financial promotions that may not have been approved by a person authorised by the FCA and that the content of such financial promotions may not conform to rules issued by the FCA; that by signing the certificate he may lose significant rights including loss of property and other assets from making an investment; and that he may later have no right to complain or to seek compensation.

In turn, businesses can promote to individuals that they reasonably believe are self certified as high net worth or sophisticated.

2.3 TIMING OF THE PROCESS

How long is a piece of string? For the fundseeker, who frequently doesn't appreciate what is involved, far too long: they want investors to rush in. Needless to say, that is the last thing an investor should (or wants to) do.

A new Business Angel should allow perhaps a couple of months to get involved with a club, syndicate or network group, plus a month or more to see some appreciable deal flow, enough to get a feel for what is around; then another one or two weeks to go through the business plans and financials of those they're interested in; and so it's going to be some four months or so from starting out to serious meetings with the first entrepreneurs.

Which, coincidentally, is the same for fundseekers: by the time they've written their plan (ten times!), discussed the ins and outs with all and sundry and finally engaged a Business Angel network, it'll be three to four months before meeting the first potential investors.

Then it's around four weeks of meeting investors/principals and key people, and a further two or three weeks in feedback and discussions.

If you're still there, you'll now be thinking about Heads of Agreement and negotiating terms, which will be another two weeks or so; around week fourteen or fifteen you'll begin to get lawyers involved and, if you push hard, you'll be signing subscription agreements within five or six months.

2.4 BUSINESS ANGEL ETIQUETTE

Every fundseeker is looking for money in order to fulfil his dreams, and may have already mortgaged his life on the way. So there is an unwritten code of etiquette for investors that makes a lot of sense: try not to mess entrepreneurs about by raising their hopes too much or too quickly.

- If it's going to be 'no', say it quickly.
- Manage fundseekers' expectations realistically
- Sign confidentiality agreements, there is no real downside and it gives spurious but genuinely felt comfort. There are various standard versions available on the web, so if the target company's is too restrictive or complex, use your own.

2.5 HOW MUCH TO INVEST?

The majority of 'serious' Business Angels commit between 5% and 25% of their total wealth, but of course this does not correlate the percentage of their wealth with their absolute wealth. There is no particular reason to suppose that the number investing a larger proportion of their money are higher risk takers as opposed to simply being much richer, and thus having more money available to put aside without compromising their lifestyle.

Given the nature of Business Angel investing, no-one should be advised to tie up any more than they can comfortably afford to keep tied up indefinitely. That is not to say there never will be a return, but it is to stress that prospective future returns are initially incalculable both in size and in timing. This inevitably means that no reliance should be placed on the 'whens' or 'how muches' of future cash inputs.

There is also the matter of further cash calls to be thought through. Every Business Angel will from time to time be asked to stump up more money for something or other. Being asked to subscribe to a Rights Issue a couple of years down the line is very common. Armed with the tools to help assess Risk and Reward, which we look at in more detail later, it is much easier to decide whether to go along with these requests or to refuse to put good money after bad. But if you do not have any actual cash left, the question should be academic: if all your 'fun money' is tied up, there is none left and so there is none to invest further.

Inevitably this is going to happen just when you really would like to invest further into a seriously promising business, and you would really prefer not to have your shareholding diluted.

The answer is to decide how much money you are prepared to call 'fun money' for Business Angel investment and put it on one side, perhaps physically but certainly notionally. Then halve it. Invest only half, retaining the balance specifically for all the future cash calls that will inevitably happen.

2.6 PORTFOLIO BUILDING

We investigate the theory behind this in the section on 'Risk Management: Applied Modern Portfolio Theory'; here we summarise the conclusions.

After you have worked out how much 'fun money' you have and set aside enough cash for the inevitable Rights Issues that will be called for, you know exactly how much money is available for investing. You then must decide what risk profile best suits your needs, so you know how many investments you have to find and make.

Every Business Angel would like to find the next Facebook or YouTube, but the realistic chances of doing so are vanishingly small. Risk and Reward tend to go hand in hand: the higher the promised reward, the greater the risk that it will not happen. Each investor must decide what his acceptable risk is, taking into consideration all the factors that we talk about throughout this book.

So you should construct a portfolio based upon your risk-reward criteria, and shouldn't change your mind half way through. Or, if you find that you must re-think your strategy, at least you should re-calculate your portfolio risk-reward profile for new deals.

And don't forget that the benefits of having a wide portfolio go beyond statistics. As we shall see later in the section on Mentoring, having access to a number of highly capable and motivated entrepreneurs is also a resource to be used to advantage.

2.6.1 PORTFOLIO BUILDING: INVESTMENT RETURNS

Sensible investing is not 'It's a long shot but it might just work', even when it's part of a portfolio approach. Venture Capitalists have access to much larger, later stage, lower risk deals such as Management Buy Outs (MBOs), and on average larger deals are more profitable. This is not because larger deals intrinsically give greater rewards, it is more because fewer of them fail because they are very tightly managed. VCs are professional investors who make hard decisions. They more often engage in financial engineering, seeking to build value in the shorter term to achieve an early exit. They have little loyalty for the management, and will change the team without blinking if it is in the interests of better returns.

Business Angel investment on the other hand tends to be smaller and longer term, invested at an earlier stage in order to support the management. It is riskier, with a higher failure rate than VC investment.

So why invest in smaller businesses? Well, for a start the rewards for success can be far greater, with very substantial profits not infrequently achieved. Target returns range from well over 75% pa Return On Investment (ROI) for start-ups to only 25% pa or so ROI for established businesses. Smaller deals are also much easier to find and access, there is a high volume of deal flow available. With so many opportunities around and VCs looking elsewhere, there is much less competition for the investment so more favourable terms can be negotiated. But they are also very hard work: the quality is extremely variable, and considerable sifting of deals and time for enquiries is needed to find the select few worth investing in.

2.6.2 PORTFOLIO BUILDING: NUMBER OF INVESTMENTS

Over how many investments should the portfolio be spread? That really depends upon the risk profile of the individual investments, and we examine this in much more detail later in the book. But as a summary, actual statistics show that of all the (known about) investments made, 40% go bust and lose the investor all his money; 24% have 0% to 24% pa ROI; 13% have 25% to 49% pa ROI; and the remaining 23% have a ROI of greater than 50% pa. This makes a practical (if not wholly accurate) sound bite: ½ will fail, ¼ won't quite fail, ⅙ will pay for the lot and one investment in twelve is likely to be a real winner.

And if you are lucky enough to find two (or more…) winners in your twelve investments, spare a thought for the unfortunate someone somewhere who therefore found no winners in his twelve…it could have been the other way round.

Later we look at the assessment of risk, how it can usefully be notionally quantified. For now it is sufficient to state the obvious, that with more risk the portfolio needs more individual investments. In order to have a very good chance of an overall return, the number of investments should reflect the risk of any of them failing. So if you are happy to take more risks with your money, say by investing in '1 in 20' chances of success, you will need to spread your investments over some 27 investments. Which is a lot, and will take a lot of time to find and manage, but if that's your strategy you need to stick with it. Or maybe you prefer slightly steadier businesses, at say a '1 in ten' chance of success: put your money into 13 deals.

Which is all very well, but more investments means more work per week, more time commitment per week, this time commitment will extend longer into the future, and there will be more time involvement in the face of competing interests. To be a risk aware, risk hungry Business Angel investor effectively means both being wealthy and committing to a full time job for several years. Or joining the right kind of investor club.

Also, given the time it takes to find, negotiate, research and invest in one desirable business, it can take years simply to build a higher risk portfolio; assuming the investor keeps faith with what he is doing. The difficulty with this is that serious opportunities with desirable risk-reward ratios do not appear very often, and when they do they will be snapped up by the first investors on the scene. Building a good portfolio is hard work and involves making yourself a lot of luck by consistently being in the right place at the right time; building a higher risk, higher reward portfolio is even more demanding.

Combining this with the need to keep half your 'fun' cash back, you will readily work out that you need to divide your available investment cash into lots of small parcels and invest an average in each opportunity. Only in this way can you be confident of having a successful investment strategy in the longer term.

2.6.2.1 Portfolio Building: Portfolio spread

To get a decent return, an investor will also want to have a good spread of risk across his portfolio.

It is sensible to spread your investments across many different types and sectors. It can be very tempting to go in more heavily from time to time, allowing the heart to over ride the head. Within tight limits there is no problem with this, but remember to keep a disciplined approach to the overall portfolio: how much is riding on each investment, both as a percentage of your portfolio and as a percentage of your wealth?

There is any number of ways to categorise different investment types. Here is one:

2.6.2.2 Portfolio Building: Portfolio spread: Stage

- Start up
- Early stage
- Growth
- Management Buy Out: These tend to have better management, and an existing profitable company. The deal is often very highly geared by using debt to create shareholder value through de-gearing. Exits are usually easier to achieve. Larger deals also have lower risk and provide more options if they under-perform. MBOs and other larger investments offer balance to portfolio but can be very difficult for private investors to access, so Clubs or Networks are likely to be the only realistic access points.
- Management Buy In: Experience of MBI investments is that, while they can succeed, the difficulty of matching management risk with investor risk gives MBIs an unusually high failure rate. MBIs rarely make profits at all, because with the benefit of inside knowledge the exiting management has had time to prepare a flattering presentation. They will leave their lieutenants in place, and by definition the junior management has already decided not to go MBO and do not have the entrepreneurial aspiration themselves. If possible, convert a potential MBI into a leveraged MBO via some form of inside knowledge. Don't be seduced by the previous experience of management as it's no guarantee of success, after all the principals have sold out.

Portfolio Building: Portfolio spread: Size

- Try to access deals in businesses with a wide range of sizes

2.6.2.3 Portfolio Building: Portfolio spread: Scale

- Ideally invest in a combination of investments with potentially high growth with those with potentially high cash generation

2.6.2.4 Portfolio Building: Portfolio spread: Scope

- An evolutionary business model is relatively safer than revolutionary, but offers less potential

2.6.2.5 Portfolio Building: Portfolio spread: Sector

- While it might be considered sensible to confine investment to a specific sector or area of familiarity, it also exposes the investor to greater risk of downside from cyclical, sector, political, competitive, systemic factors and so forth

2.6.2.6 Portfolio Building: Portfolio spread: Personal Preference

- Unless an investor is trying to collect a synergistic group of businesses for a larger strategic purpose, locality is usually very important to lifestyle: few would choose distant investments where there is or might need to be any form of direct involvement.

But how can the Business Angel Investor have his cake and eat it? How can he both back only those businesses where he knows and understands the sector, and at the same time get a sector spread in his portfolio? Both have the time to be directly involved to assist Management, and have investments spread over a wide range of opportunities? Have influence in his investee companies, yet spread his (usually finite) resources over enough investments to maximize the chance of reward? The personal involvement of the investor dramatically improves the chances of investment success, and being involved with other investors also greatly enhances the available spread of knowledge skills and experience in looking after money.

As a potential Business Angel investor, joining investor clubs and networks is far and away the best way to get involved with looking at, discussing and dissecting deals. Such involvement also has the enormous advantage of allowing collegiate investing.

2.7 COLLEGIATE INVESTING

Collegiate investing through Investor Clubs increases an investor's investment spread and reduces his exposure to any one deal, while maintaining his involvement in the whole portfolio and probably increases his fun. Sharing and syndicating allow bigger pots, pooled money, portfolio diversity, more skills and experience; the work involved in Due Diligence can be shared, there is a division of labour, a sharing of leads; a Collegiate approach gives all involved stronger negotiating power, and is more influential on Boards. There are equally obvious economies of scale when meeting potential investee companies, and negotiating terms can be dramatically facilitated when the interests of several experienced businessmen coincide. Both risks and costs can be shared. There really is no area of activity which is not enhanced by acting collectively. The major downside, as with all organisations as they get bigger, is that decision making gets longer and less straightforward, possibly leading to extra frustration.

An Investor Club can be described as a grouping of like minded investors who share common goals and ideals, bringing together a wide range of expertise for knowledgeable analysis and discussion of deals. Being involved in a club gives each individual access to a wide range of skills and experience, thus adding greatly to an individual's ability to invest in businesses of which he personally may have little knowledge. Thus if in a club there are those having extensive, senior and personal experience of an unfamiliar sector the others may wish to follow them passively should they find an opportunity in which they have confidence to invest. And, naturally, if there is a reasonable spread of such experience in the club, then each member might find two or three businesses he can personally mentor while others follow passively. In this way, with several active members in the club each might have two or three investments in which he is active as director and mentor, with a dozen or more in which he has simply passively followed his colleagues more experienced in other areas. So each of them achieves good spread, in businesses chosen by experts in their field, with active involvement either directly or indirectly in each.

As well as being socially fun, Clubs also encourage investment by allowing novice investors to gain vicarious experience without risking any money, and provide opportunities to co-invest with more experienced investors; this is especially relevant if the club's members include experienced successful Angel investors.

2.8 BUSINESS ANGEL NETWORKS

The first 'arms length' Business Angels networks (BANs) were operating in London by 1982 and in the rest of the UK there were several by the early '90s. There are currently dozens of BANs in the UK. BANs with a regional geographic coverage are generally required to become Full Members or Associates of the British Business Angels Association (BBAA). They can be commercial, public sector, commercial with a public sector focus, or not-for-profit organisations. Many BANs have close relationships with the private banking sector and the venture capital industry.

But there needs to be a word of warning writ large on most Business Angel Networks. With few exceptions, they do what they do either to make money from the fees they charge, or to demonstrate a successful track record to their sponsors in terms of opportunities funded. Both of these mean that they are more interested in completing deals than they are in looking after an individual Angel Investor. This is not to say that they inevitably act against the investor's interests, but the records will show that the vast majority of those Business Angel fundings that have been arranged through Networks involve just one or at most only a few investors. Being the sole investor in a deal may easily be both practical and possible if you have very substantial funds at your disposal, but for most investors they will have over invested in one deal and have insufficient resource for enough spread of investments. Business Angel Networks are essential components of the marketplace, but each individual investor needs to be sure that after careful reflection his interests and the Network's coincide.

Sources of information on the higher profile Clubs and Networks are readily available simply by Googling. To gain access to more private arenas you will need to demonstrate some networking skills of your own; but isn't that what success has always been about? The size, structure, formality, constitution, cost, and focus of any club and network may well differ widely, and involvement in more than one has further advantages. The only points to be aware of are fairly obvious: ensure there are no regulations or laws that trip you up, for example from the FSA, Data Protection or Inland Revenue.

2.9 DEAL FLOW AND OTHER RELATED MATTERS

Having decided that it's worth looking further into Business Angel investments, you need to follow up your decision by having a look at deal flow and investment strategy: where to find deals, what to look for in general and how to approach deal analysis. Then, when you've got enough deals to look at, you need to achieve a balanced portfolio with the right risk profile.

A combination of being involved in several Business Angel Networks and active, suitably structured Investor Clubs has numerous real advantages for each individual. Deal flow just happens, and frequently the deals will have been qualified or pre-screened. Investment proposals will often have been tailored and summarised into clear and concise documents.

Of course, clubs and networks are not for everyone: some people prefer to work alone. While it certainly has many disadvantages, it does give an individual his own channels and independence. He is beholden to no-one, and can take his own decisions. And, again while it is more effort, there are many opportunities to make your own deal flow.

Anyone wanting to explore this approach should read all there is about Business Angel activities, go to conferences and networking events, subscribe to specialist publications, regularly scan the wide range of opportunities competing for attention on the web, take up business consultancy opportunities, maybe even study or teach entrepreneurship, or even write about it. Simply judiciously letting it be known that you are in the market for interesting opportunities will bring its own reward, be it from work colleagues (especially senior ones), down the pub, from friends and family, or maybe think about attracting interest through social and business networking sites and blogs on the internet.

2.10 PERSONAL CONSIDERATIONS ABOUT INVESTING

The first step is to have a thorough look at yourself, and decide if the upsides of Business Angel Investment outweigh the downsides. Think about how much you are prepared to put in and compare it with what you are able to bring to the party. The more you contribute, and the more skills contacts experience and knowledge you bring, the smaller will be the risks. What are you looking for by way of Reward: Money? Involvement? Mentoring? Contributing? Being useful? Can you be flexible if needed?

- What is your Risk Profile: do you want to sleep at night? Certainly there are many Personal Risks to lifestyle, but which is greater, the risk of investing, or that of not investing?
- What is your tax position? Can you derive extra investment leverage through favourable tax breaks?
- Reputation and Privacy Risk: do you mind if people know you are a successful Business Angel? Or, given the high chance that Business Angel investments sometimes fail, what about being known as an unsuccessful one? Privacy can be maintained by limiting those who know you are a Business Angel to deal-flow introducers and fellow Angels on a 'need to know' basis. Those high-profile Angels who 'go public' have a high quality deal filtering system between them and the many zany inventors who try to seek them out.
- Personal situation: how strong are your existing personal relationships in the face of inevitable losses? Or alternatively what if the investments come good? What would be the impact on those relationships? Everyone has more losses than wins: do you care? Would failure mean having any losses at all, because they are inevitable in every portfolio; or would being successful mean finding any winners at all, because that will happen with equal certainty if the portfolio spread is big and wide enough.
- Involvement Level: Are you a control freak? Are you reluctantly going to get sucked in? Or would you just trust them get on with things?

- Time Risk: how much Time do you have for investigations and other commitments? If you are unlucky, you can get caught. Investments that win are great, and investments that go bust are very disappointing, but they happen; it's those that continue to promise returns that can cause difficulties, especially if there are management issues that you allow yourself to get sucked into.
- Location: how far, taking how much time, are you prepared to travel for the right deals? And then continue to do so regularly?
- Isolation Risk: being the lone voice on the Board, even (especially?) when you are in the right. One Business Angel we know refuses to be the sole 'outside' director for just this reason: he insists upon having someone else share the burden of keeping the entrepreneurs on plan.

Or maybe you just like the thought of investing so long as there is someone else, a lead investor, taking all the Personal Risks? There is plenty of room for your money, so don't be put off.

2.11 SUMMARY

Understand why Angels do not make more investments:

- Lack of business proposals matching their investment criteria
- Lack of quality business proposals
- Lack of trust in the entrepreneur or management team
- Lack of experience in pricing deals
- Lack of experience in due diligence and monitoring
- Lack of available funds

Simplistically, there are ten Golden Rules to bear in mind when considering a Business Angel investment.

- Understand the Risks
- Spread your risk
- Structure to minimise risk
- Co-invest/syndicate
- Invest where help is needed alongside
- Be thorough with due diligence
- Invest only where you feel comfortable
- Don't back a one product business
- Be fair with valuations, it's a relationship that needs to work
- Think 'exits'

And one sure-fire way of losing money as a Business Angel:

- Treat it as a hobby: it is a serious business, just as any other.

But that should not stop it being fun, if approached with the right attitude. Far too often, 'serious' is confused with 'solemn' or 'boring': it can be both, but need be neither!

To get a decent return, you will want to have a good spread and to be involved with others in looking after your money. Anyone with an interest and as little as £50,000 can make a genuine contribution. True, they probably won't get major shareholdings, but their money and involvement will still be very much appreciated, and it all helps.

3 THE APPROACH

In which we describe the background to our philosophy.

Business Angel investment may be risky, but does that mean it's also dangerous? In order to achieve a perceived reduction in risk, people are frequently advised by experts, both genuine and 'down the pub', to invest in ways that are intuitively sensible. The biggest problem with using this approach exclusively is that success in many fields is often not intuitive, or everyone would be doing it. This is especially true in Business Angel investing, where a successful strategy often arises from things which on the face of it go against 'received wisdom' and intuition.

The whole point of investing is to make a profit. Easy to say, but how does anyone work out what to expect in Business Angel investments?

All business decisions might be described as ultimately based upon an assessment of cost-benefit, whereby the benefits of a course of action must outweigh the costs. To invest with any expectation of success, a considered and structured approach to Risk assessment and management is essential.

The model we introduce uses existing theories and practice to provide an approach to enable investors to make a quantitative assessment of each of the several Risk factors inherent in early stage investment; then combine this with a quantitative assessment of the potential Rewards available; and assess and factor in all the wide range of Uncertainties – variables – that have significant influence on business outcomes.

The approach is heavily subjective, and does not claim to invest the judgements with spurious rigour. Specifically, it does not give or claim to give an absolute quantitative measure of risk. But that said, for any one individual or group of individuals who can use the model and their judgement consistently it does provide a unique method of judging the relative merits of different and disparate opportunities. We thus have a model that gives very substantial help in business evaluation, and also greatly assists entrepreneurs in building plans specifically addressing investors' needs and concerns.

It enables entrepreneur and investor alike not only to ensure that benefits outweigh downsides, but to manage time and money to optimize outcomes from disparate inputs. The Model helps do just that in many ways:

For the investor, it:

- Helps assess relative merits of different business opportunities
- Helps assess dissimilar investments
- Helps build balanced portfolios
- Helps judge where to make what investment of how much time and/or how much of money
- Helps define meaningful performance milestones
- Helps optimise portfolio performance
- Helps optimise and speed exits

For the entrepreneur, it:

- Provides a results-oriented planning tool
- Provides insights into shareholder thinking by making entrepreneurs 'reward aware'
- Provides a simple vehicle to make entrepreneurs 'risk aware'
- Focuses management thinking on weaknesses and controls
- Helps businesses become investment ready.

And by giving both sides the same tool and perspectives, it facilitates valuing and structuring deals.

There are three unknowns underlying the assessment of this problem:

- How is the size of the potential Reward assessed?
- What is the likelihood of the Reward being realised: what are the Risks, and how are they quantified?
- How confident are the calculations: what is the range of outcomes upon which a decision is being made?

Informed decisions can be made based upon the results of a reasoned assessment only if there is confidence in the method of assessment, and if the input variables that are being assessed are properly understood.

4 THE MODEL

In which we outline the basic parameters to be used in the model.

The model uses a very simple formula: Return = Risk × Reward, where Return is the likely financial profit for the investor, Risk is the chance of the profit being realised, and Reward is the projected profit from any one investment. In this way, if the Reward from an investment is projected as 3-fold and the Risk is assessed as 1 in 5, then the overall Return would be 3 in 5, which is not worth doing as it is less than one. But if the Reward for the same Risk were to be 15-fold, the overall Return would be 15 in 5, or 3 to 1, and a worthwhile bet.

The several Risks associated with a business are identified and dealt with practically, in the same order as happens in practice. First, a business plan is read and analysed: the named risks are

Vision: (Concept, Marketplace, Evolution/Revolution, Focus, Size, Scale, Scope and Timing)
Stage
Business Model: (Marketing and Sales, Operations, Resources, and Finances)

If the plan is sufficiently encouraging, the principals are met. The risk factors associated with them are

People: (Character, Experience, Capability and Knowledge)
Motivation

Each of these is analysed subjectively but consistently and given a score out of ten based upon both the written plan and the competence of the management. This is combined and weighed against the potential Rewards, which are calculated separately using a number of different approaches.

Please note that we are not claiming that this way of measuring risk gives it any inherent absolute value. We are not saying that if you assess a risk as 'one in five', then it has a one in five chance of coming off and a four in five chance of failing. But we are saying that, after using the system and gaining experience of making the risk judgments, a 'one in five' risk is half as risky as a 'one in ten' risk, and a 'two in five' risk is half as risky again.

The method provides a degree of objectification when making comparisons between such disparate opportunities as a new burger chain, a new mobile app, novel fuel injection and a new film production company. Combining these Risk assessments with the Reward calculations really does provide investors with a tool to use when appraising different investments, and it gives entrepreneurs an insight into how best to structure and present their plans.

We look in detail how each of Risk and Reward can be assessed later, but it is useful first to consider Uncertainty as it impinges very significantly upon both.

5 UNCERTAINTY

In which we look at the variability of measurements and assumptions.

Have ever even seen a real business where they actually get paid exactly in 30 days? Not a day early or a day late, ever?

And have you ever seen a business plan where exactly that is assumed, and the entire cash flow forecast depends upon such payment terms being strictly kept?

That such a business is in practice almost absurd is well known to anyone who has ever run a business. Yet every business plan projects forwards making many different fixed assumptions. Fixed assumptions about when it collects its debt, fixed assumptions about how much things cost, fixed assumptions about how quickly purchases will be delivered, fixed assumptions about how inflation and material costs will impact on growth…and so on? Of course, spreadsheet technology is a major factor that limits any alternative to this approach, but that does not make it true in the real world. A real business that demands payment in 30 days is actually doing quite well if it gets paid in anywhere between 30 and 50 days, and surely the impact of that variability on all projections needs to be considered very seriously.

Making allowance for the variations that 'real life' brings into the equation can have a major influence on the way a business is managed and valued, and also highlights those areas in the business where value is most quickly lost. And we call these measurable real life variations in important parameters the 'Uncertainty' in the assumption.

Uncertainty is not at all the same thing as risk. Use of Uncertainty gives us the confidence level we need to ascribe to our judgments and calculations.

In ordinary use the word 'uncertainty' does not inspire confidence. However, when used in a technical sense as in 'measurement uncertainty' or 'uncertainty of a result' it carries a specific meaning. It defines the range of values that could reasonably be attributed to the measured quantity. It is often stated by giving a range of values which are likely to enclose the true value. This may be denoted by error bars on a graph, or as value +/- uncertainty, for example the debtor days above could be expressed as 40 days +/- 10 days; or a business valuation could be shown as 'The value is £1,000,000 +/- £400,000'. When uncertainty is evaluated like this it shows the level of confidence that the value actually lies within the stated range, and is often calculated to a confidence level of about 95% (for the statistically minded, one standard deviation). This means that in the above examples the debtor days will be between 30 days and 50 days 95% of the time, or in the other example that 95% of the time the valuation of the business will be anywhere between £600,000 and £1,400,000.

The impact of using the principle of Uncertainty on valuation of Reward, and on Risk Management at both investment stage and later, is profound and more than merits getting to grips with it.

Inevitably in early stage investment the variability associated with the business plan assumptions will be assessed as 'above the norm', and the uncertainty range will be wide. This is, of course, not as nice as being able to be precise, but it is what it is. We need to maximize our use and understanding of both Risk and Uncertainty in order to give the best chances of winning, both on the individual deal and at the portfolio level.

Assumptions used are of their nature fixed numbers in order that they can be easily projected, whereas in practice the values will vary. There are two issues here. The first is to calculate what impact the Uncertainties have on the projections, which can be done by a competent spreadsheet practitioner; and the second is to determine just how variable the parameters will be in practice. Another way of saying the same thing is 'How good are the management at managing? How well can they control what's going on?' It is how the management deal with Uncertainty that matters; how they minimise the Uncertainty, making their projections more believable and their results more achievable.

In a traditional business plan, each of the financial assumptions is typically specific and a gross simplification on real life. By using the concept of Uncertainty, each of the numerical assumptions in the business plan is given a range of values to try to reflect reality, rather than one specific number. Each range is allocated with the help of and after detailed discussion with the Principals, and their proposed plan implementation. Because this is done with the agreement of the Principals, when the ranges of assumptions are used to re-build the plan projections the projected ranges of forecasts have unarguable authority.

Inserting mutually agreed ranges for assumptions rather than simple numbers has two major impacts. Firstly, it provides an authoritative range for business valuation purposes, and is used in the calculation of Reward. And secondly, those areas in plan implementation that are most vulnerable are highlighted, as are those which are most amenable to influence. This gives both investor and management a very useful Risk Management system, and also provides the investor with a unique process to help when deciding investment priorities.

6 ASSESSING RISK

In which we analyse in detail how an investor assesses the risks of an investment

6.1 Risk
6.2 Quantifying Risk
6.3 The Business Plan
6.3.1 The Business Plan: Vision Risk
6.3.2 The Business Plan: Stage Risk
6.3.3 The Business Plan: Model Risk
6.3.3.1 Model Risk: Sales and Markets
6.3.3.2 Model Risk: Operations
6.3.3.3 Model Risk: Resources
6.3.3.4 Model Risk: Finances
6.3.4 People Risk
6.3.4.1 People Risk: The Entrepreneurial Temperament
6.3.4.2 People Risk: Character
6.3.4.3 People Risk: Experience
6.3.4.4 People Risk: Capability
6.3.4.5 People Risk: Knowledge
6.3.4.6 People Risk: The Team
6.3.5 Motivation Risk

6.1 RISK

Many people do not properly understand the nature of 'risk'. Risk per se is not dangerous; it is the consequences of what happens should the risk occur that might be. When given the choice between a high risk or a low risk occurrence, most take the low risk option; a few, possibly suspecting a trap, take the high risk option; only a small minority ask "risk of what?", and of course they are right. The original question is fundamentally flawed, because it does not give any information about the consequences of the occurrences: but it very frequently catches people out.

The factors that allow unpredictability to creep into an outcome are risks. Each risk has two components:

- The likelihood of it happening, and
- The impact it has should it happen

In a business environment, these are most easily distinguished by considering two simple situations.

It is quite common in any business that from time to time human error will cause invoices to go out late. This is annoying and might cause some local difficulties, but it is unlikely to cripple the business. The risk is likely, but relatively trivial.

On the other hand, it is very unlikely that a dishonest employee will remain undiscovered for long enough to embezzle a business-crippling sum of money, but it could (and sometimes does) happen. This risk is then unlikely, but major.

How is it simplest to assess these considerations when looking at risk?

Clearly the first step is to recognise what risks are threats. This is probably the easy bit to do. Business is all about recognising what might go wrong, assessing and pre-empting it with sensible actions.

The major way to make an initial assessment of the risk factors in Business Angel Investment is enquiry: check it out. The term 'Due Diligence' can be used, but it is more often misused.

It can be useful to consider two aspects of these enquiries: firstly, whether or not to invest, and secondly what is being invested in. This latter we will call 'Legal Due Diligence', and where an existing business is involved, you will obviously want to make rigorous and exhaustive checks into its status, shareholders, residence, the claims of its managers, tax, insurances, trading history, employment status, potential litigation and so forth. We will look at how far this needs to go in the section on Doing a Deal.

But, this comes after you have decided that you are interested in investing in the first place: this decision, especially in a new or start-up business, is best and most efficiently done through simple enquiry. Find and ask someone independent of the business who knows the market, technology, product space, model, people….

Clearly the rigour and extent of the enquiry process is up to each individual and situation. We will look at this in more detail after we've looked at the Business Plan and once we've met the People. That's when the real digging starts.

6.2 QUANTIFYING RISK

Traditionally, 'risk' is found by multiplying the likelihood of occurrence by the severity of impact. Unfortunately, this is less helpful than it might be because, while the mathematical product would be the same, the impact on a business of a 'likely but trivial' risk is actually quite different from that of an 'unlikely but major' risk.

This is the matrix we will use to assess the size of any specified risk:

5	4	3	2	1
7	6	4	2	1
8	7	6	3	1
9	8	7	4	2
10	9	8	5	3

Likelihood ↑

Severity →

'Up', or the y-axis, reflects the likelihood of a factor happening, while 'across' or the x-axis is a measure of the severity of the impact the factor will have.

Note first that the 'scoring' system is upside down: we're giving a lower score to higher risks and a higher score to lower risks. A likely and major risk is a 1, whereas an unlikely and trivial risk is a 10. This is to make the system useful to us in assessing business risk factors. Think of the score as 'marks out of ten' for the positive things, the chance of a successful outcome. The riskier you see something to be, the smaller you assess the chance of success and so lower the mark you give it. When we assess the subjective 'riskiness' of several factors, this approach allows us simply to multiply the numbers together to arrive at an overall riskiness mark.

When considering any particular factor, you will need to decide whether it has more of a 'likelihood' or of a 'severity' character. Complex factors, like real life, will obviously have components of both, but the trick is to isolate particular factors into their simplest components, which are likely to influence just one dimension.

All this is purely subjective. Every risk factor you assess will be done subjectively, upon considered reflection and preferably after discussion with other informed people. The more anyone does the analysis, the better and more reliably consistent will become his judgments. It's a bit like learning the violin: horrible at first, but with practice it can become deceptively simple. This matrix is not intended to give specious rigour to the results of the analysis, but simply to provide a framework with which to think about risks and their impacts. By providing such a framework, you reflect upon what are the basic risk factors and influences, and arrive at a decision about the nature, likelihood and severity of the risk. Then at any rate you have something constructive to work with when deciding what to do about it.

We use this matrix to help assess the five identified business risk factors: Vision; Stage; Business Model (Finance Operations Resources Market); People (Character Experience Capability Knowledge); and Motivation. Each of these is analysed subjectively but consistently and given a score out of ten based upon both the written plan and the competence of the management. To work out the total risk, we simply multiply the assessed risks together. This is combined and weighed against the potential Rewards, which are calculated separately using a number of different approaches.

Thus, if we assess the five risk factors as being 10/10, 9/10, 10/10, 7/10 and 4/10 we combine them into an overall riskiness of $10 \times 9 \times 10 \times 7 \times 4$ divided by $10 \times 10 \times 10 \times 10 \times 10$, which is 25,200/100,000 or around 1 in 4 (given the inherent subjectivity and vagueness of the values involved, it's always worth rounding to a simple number).

It is also worth noting at this point that while multiplying the risk factors together makes sense, it also makes it very difficult to come up with winners, just like the real world. For example, a 50-50 chance may not be too bad: give it 5/10. But multiplying together 5 risk factors all of which are 5/10 gives us a result of 3125/100000, or about 1 in 30. That's like backing an outsider at Aintree. So later on in assessing the various business risks, we are looking for eights nines and tens out of ten, with the occasional four or five allowed, but just the one unless you really know what you're doing.

Secondly another important note is that the matrix is asymmetric. This is because, as we have said, risk factors are asymmetric: the recognition, assessment and management of a 'likely but trivial' risk differ in quality from those of an 'unlikely but major' one. This does not mean that the latter can not be coped with, merely that they have to be properly assessed. Understanding what to do with which risks is the key to success. In practice the process of balancing 'likely but trivial' risks against 'unlikely but major' ones can be very difficult, and we look at Risk Management later.

6.3 THE BUSINESS PLAN

Now we look at Business Plans: what to look for, and how to decide if it's worth meeting the authors.

It's worth making a quick note to clarify one essential point: a business model is often easily confused with the management's ability to implement it. The model is 'management independent', it is a matter of theory: is it elegant? Should it work? Are they making life difficult for themselves? How competent would they need to be to implement it, or do they depend on 'magic moments'? Have they remembered they can only recruit people, not Super Heroes?

It is important to understand what the Business Plan is for. A well written and structured Business Plan should, of course, describe as accurately as possible the business opportunity and potential outcome, incorporating a clear summary of how the outcome is to be achieved against what odds. But it was written specifically to attract you, the Business Angel, or at least it should have been if it is to succeed.

Can they say it simply and with clarity. As Winston Churchill famously said: ‘I am going to have to make a long speech tonight because I’ve not had time to write a short one’

There should be an elevator pitch to point you in the right general direction, and a brief executive summary to give you a first pass at understanding the business. If there isn’t, it implies that the author may not really understand what he is doing. Can you tell who wrote the plan? The entrepreneur, or an adviser? Who owns the ideas? Is it a plan or a wish list?

Was the plan written as a strategy for the writer, to give him a road map? Are the principals knowledgeable?

Or do they come across as ‘winging it’? And what is the audience it was written for? A bank, management peers, funders, or whom? Each audience has a significantly different requirement of a business, and a well written and targeted document will appeal specifically to exactly that audience. The implication of this is that a poorly targeted document again reflects badly on the author, and the reader has to be concerned about whether the author really understands what sort of funding he is trying to get, and what he is really trying to do.

Great entrepreneurs don’t have to be great writers, so when you read a business plan it may be a mess. Yet even so there may be something in it that you can see has the essence of a brilliant opportunity. But if reading through it is hard work, clearly the author either has significant communication difficulties, or is too entwined with the technology, or both. Is it meant to be something to make money from, or to build the entrepreneur’s ego?

It all boils down to whether at first run through you think whether or not there’s a chance you could make money out of it. How do you rate the assumptions they have used to build their Financial Model? What are the Uncertainties? And will others also make money out of it? If so, then the secondary but highly important issue is if you think you could work with these people?

If you are still reading it, there clearly has to be something in it to get your juices flowing. This is when we need to get down to the nitty gritty: what is a good approach to evaluating the risks?

6.3.1 THE BUSINESS PLAN: VISION RISK

Vision is what gets you going. If there’s not much Vision, you’re not excited so you won’t invest (unless maybe the entrepreneur is your nephew). So Vision has to score very highly, by definition.

There have been millions of ambitious business plans, and one or two have actually come about. Microsoft started by envisioning 'a PC on every desk'. Did that sound ambitious then? Think of Amazon, eBay, Facebook, Google, Skype…. Does the business you are looking at have good growth potential? Does it fly? If they can excite you there's a chance they might excite a customer: how are the hairs on the back of your neck?

What are they trying to achieve? Where are they going and how are they going to get there: how realistic is it? The realisation of Vision can be a problem: is it a Vision or a Dream? If you get Vision wrong, you'll be starting again from scratch, but it's difficult to see how Vision could be misjudged. Does it plan to grab the world, or not?

We break Vision down into various component parts, and look at them in turn.

6.3.1.1 Concept
6.3.1.2 Marketplace
6.3.1.3 Revolution/Evolution
6.3.1.4 Focus
6.3.1.5 Size
6.3.1.6 Scale
6.3.1.7 Scope
6.3.1.8 Timing

6.3.1.1 Vision: Concept

What is really unique about the proposed concept? Is there anything really original about it? What are its inside track and unfair advantage? What makes it tick? Does it promise recurring revenues…how good could it realistically get? And how are they proposing to ensure they do it?

6.3.1.2 Vision: Marketplace

The context of the business in the world at large is inevitably key: how does it interact with what is already in the Marketplace? How possible is it that competitive pressure could significantly and adversely affect the model?

What is the macro environment this opportunity is attempting to flourish into? Perhaps more to the point, what is the macro economic environment itself doing? For example, what are general economic trends and are there any sector specific trends? Which way are any technological and social trends moving? What is existing mainstream manufacturing and international competition doing? What might help or hinder?

What's the market like? Is it fragmented, or alternatively a monopoly? Who controls the market? Are there any 'on-off' factors? Are there any pre-existing entrenched positions, vested interests or standards? How mature is the sector, what barriers to entry exist and what could they introduce themselves? What is the cost of such entry?

How likely is it that any potential competitors will take unassailable advantage through contract, relationship, price, technology lock-out etc? If there is no competition, is it because the market does not really exist?

Are there any requirements for regulatory compliance? What will this cost?

Does the business depend upon an existing widespread infrastructure, or could it need to create one from scratch as in LPG (Liquid Petroleum Gas) solutions or communications? Can any suppliers control critical resources?

What is the expected time to market (multiply this by at least two!), and what follow on opportunities exist? How do they see alliances being created to leverage their brand?

Finally, why not check the Press and do a background web search, whilst maintaining a healthy scepticism about ill informed journalists.

6.3.1.3 Vision: Revolution/Evolution

Is the opportunity evolutionary, in that it is taking a new stance or development on an existing technology or market? Will find a receptive market keen for better? Or is it revolutionary, disruptive? Is it going to have to educate everyone about something new, no matter how good? If so, how much money will need to be thrown at it for it to succeed?

6.3.1.4 Vision: Focus

Is it a one-product business? Or worse, a one-product entrepreneur? Even worse, is he so full of great ideas, possibilities and opportunities that he finds it impossible to focus on actually doing one? Or is there a sensibly balanced plan?

6.3.1.5 Vision: Size

'In early stage deals, size matters'. So how big are they to start with and how far do they have to travel: what is the upside, how big could it get? How many difficulties stand in their way and will they have the capacity to win? Does the ultimate potential return beat the initial risk?

6.3.1.5 Vision: Scale

What would be needed to increase sales a thousand fold? Are there any economies of scale as volumes increase?

6.3.1.6 Vision: Scope

Are there any synergies with other products or services that can be exploited on the back of successful sales, customers, relationships or brands?

6.3.1.7 Vision: Timing

As an Angel investor famously said: 'If you think you have identified a real opportunity, then you better go like mad into the market.' Is there evidence that customers will buy now? Who else is doing, or is about to do, the same thing? Is there any money to be made now, and will it be sustainable, and for how long?

Now to quantify all the above. Make a judgement about each of the eight Vision Risk factors, and give each a score out of ten. The better your assessment, the closer to ten should be the score. So, for the moment ignoring the other risk reward factors which may have downsides, if the opportunity is one you absolutely have to be involved with give it a ten. If you find yourself dreaming over the potential, and wondering if you would kick yourself if you were to miss out, give it a nine. If you find it highly compelling and can see it fitting nicely into your portfolio, but no more than that, give it an eight. If you can't give it at least an eight, don't bother as you'll not be investing anyway. Then give Vision a provisional combined mark out of 10. Why is it provisional? Simple: wait and see the Principals, and then review the score if they can convince you!

Please keep your score: the 'Vision' score contributes the first of the five 'risk' bits in the 'risk-reward' calculation.

6.3.2 THE BUSINESS PLAN: STAGE RISK

David Berkus is one of the original Californian Business Angels and is renowned for his thoughtful and practical contributions to Business Angel thinking. He has written several books on the subject, and devised his own method for making rough valuations of early stage businesses. We use his logic as the basis for estimating early stage risk.

Consider the main Business Risk factors – Vision, Model, Operations, Resources and Finance – and allocate a 'stage value' to each: how mature, developed, proven? Or still just a good idea?

Description of Stage	Mark for Stage risk, out of 10
The principal has an original idea and claims to be an expert	1
The technology/prototype is nearly finished, and money is needed to finish the work and market it	1.5
The product is finished and tested, money is needed for marketing and to build a team	4.5
There is an 'early adopter' sale and a major company has expressed serious interest. The Board needs strengthening	6
There are sales contracts and proven expressions of serious interest. Money is needed to deliver	8
There are repeat sales and money is needed to grow. The technology works and there is more on the way. There is have a rounded team who can and do deliver	10

As a useful rule-of-thumb, consider these estimates for the various Risk factors as guides and use them to derive a number for Stage Risk as a mark out of 10. And if you don't think the answer quite hits your mark, change it: it's only meant to help!

Please keep your score: the 'Stage' score contributes the second of the five 'risk' bits of 'risk-reward'.

Stage is what it is: if it's very early, you know it's riskier. Factor it in, of course, but don't discard on Stage alone. It is important, but not essential: if you have excellent Motivated People with good Vision and a Model that is realistic and simple, and doesn't rely on re-educating the world, you can cope with a low Stage score on Risk, especially if you are going to be closely involved.

6.3.3 THE BUSINESS PLAN: MODEL RISK

Assuming that their Vision sits comfortably and potentially realisably in the Marketplace, we move on to the four pillars of the business Model:

- **Sales and Markets:** what is to be sold and to whom
- **Operations:** how is it to be organised
- **Resources:** what are needed to achieve all this; and,
- **Finances:** what money and information are needed to keep the rest on track

6.3.3.1 Model Risk: Sales and Markets

This is the most basic consideration of all: without a market, there is no business.

How big is the market? How mature is it, and with what potential? Does the entrepreneur demonstrate that he really understands it?

6.3.3.1.1 Model Risk: Sales and Markets, Sales

Do they have a believable way of generating revenue and how are they going to achieve it? In practice there are any number of ways of doing this, with no unique solution or right or wrong way, so does their way make sense? How do they capture this revenue from the marketplace? How does the business convert expertise and resource into bank balance?

What evidence can they provide that there is demand out there? Who is the customer and has anyone bought yet: are there any letters of intent or other proof of value proposition, other than from friends and family? Why will customers part with money? And keep on doing so? How much? How many? To whom? How often? Profitably? How achieved? How repeatable? Without costing too much to serve? At rates that allow profits to be retained?

What are those customers doing now as an alternative? What alternatives do or could exist?

How accessible is the market? What's the Sales and Distribution strategy?

What are the marketing costs? What are the sales conversion ratios and is there any evidence to back this up?

Is there a Regulatory or Compliance reason the product or service should be bought?

Market reports can be very useful sources of background research, but readers should be careful as the researchers don't have their own wealth riding on their reports!

6.3.3.1.2 Model Risk: Sales and Markets, Product/Service

Have you ever seen a solution without a problem? How many great ideas have there been for useless things that no-one wants? Maybe that's an unkind exaggeration, but take a look through the records of the Patent Office and you will get the picture.

On the subject of Patents, what's the IPR (Intellectual Property Rights) position? Is the product owned? Is it protected? Intellectual Property is highly prized because a Patent, or better still a ring fence of Patents, makes a good barrier to entry. But while getting a Patent granted is relatively easy, getting it granted throughout the world, and especially keeping one throughout the world, becomes very expensive. Often this means that even though there is a Patent, prohibitive costs have forced the entrepreneur to cut corners and leave holes in the claims or protection. This means that the better the commercial outlook for the device, the more likely it is to come under the competitive scrutiny of major competition, and major competition tends to have very deep pockets. What is the litigation risk? Is Patent protection insurance a consideration? Better still, do you know – or can you find – any good IP lawyers who will work on a 'no win no fee' basis?

Does it work? What are its main features and benefits? What competitive edge does it have? What technological dependencies are there? What is the probable technology lifetime of the product? And if it is highly technical, what are the chances of cost efficient manufacture?

Can it be made and delivered to a price and on time? How much will it really cost to be market ready? Is the profit potential enough to give a satisfactory return on investment of capital, time and opportunity cost? The closer to the concept stage the more likely the investor is to having to roll up his sleeves and get involved, and obviously relevant industry knowledge becomes ever more important.

Many successful start-ups have been founded by entrepreneurs who left established companies where they identified a niche market their employer did not want. Often, the new business has the former employer's blessing, and he may even have sold or given it away. But, whilst this is undoubtedly true, it is also worth checking that the entrepreneur's former employer really didn't want to enter the market. If there's any deception or skulduggery involved any investor should drop it instantly.

6.3.3.2 Model Risk: Operations

If the sales and marketing model is believable, once they've captured the demand can they deliver it in a way that makes sense? Are the Operations in line with and sensitive to the planned growth? Is the administration thought through, at sensible salary levels? Do they look effective and efficient, and how competent would management and staff need to be for it all to work smoothly? Have they remembered to allow for errors frailties and imperfections?

If there are any requirements for regulatory compliance, have they been thought through definitively?

What controls and systems are proposed?

Are there any show stoppers?

6.3.3.3 Model Risk: Resources

Have they got the right amount of – whatever! – to make it work? Without wasting cash on over supply, yet without being under-resourced? Enough of the right people in the right places? Enough physical space, both for people and for things? Transport, logistics? Information? Technical? Intellectual?

What skills resources and relationships does management already have? We're not looking here at the entrepreneurial flair of the Principals, you haven't met them yet and we cover that under People Risk, but we are looking at whether you can tell if they appreciate the sheer management issues of resource availability and allocation, and can cope. Have they ever been through the pain barriers of, for example, recruitment and providing training? Do they actually know what it takes? Or, somewhere in the middle of the plan, do they say they will recruit a sales force, and from that point on sales increase exponentially?

What are the potential problems and disasters? Are there enough resources to cope with the unforeseen? If not there'll be a very high chance of an unplanned future rights issue, and in this case be prepared to say 'no' on the principle of 'good money after bad'.

6.3.3.4 Model Risk: Finances

This pulls together everything in the model that you've looked at. How sensible is it? This is not just about the obvious question, is there enough? It is about whether there are any key dependencies or drivers, and are there any major weaknesses? Do the principals actually understand finances and who needs what when, for if they don't how can you trust your funds to their stewardship? Does it read as if they own their plan, or as if the numbers are an added afterthought?

What assumptions are they basing their projections on, and do they seem sensible, realistic? Are the financials complete, and have they included their own assessment of sensitivities? It is worth noting that 99% of plans never achieve projections, mainly because the vast majority of plans assume that everything goes perfectly without hindrance, rather than that they will have to operate in the real world.

We have identified 16 independent variable assumptions that contribute to a Business Model, each of which is 'Uncertain'. The following parameters all have values which, if relevant in the Plan, have to be assumed by the Principals and are built into the assumptions used in forecasting their business model financials. Each of these is, give or take, a variable, some more than others. Some may be more within the control of management than others, whilst variations in others might require management to be responsive and flexible. But each of the following can potentially vary in ways that will have major impact upon the business model and forecasts, and all the potential variations have to be factored in.

Description of assumption		Uncertainty
Sales Volume starting figure	£	+/-%
Sales Volume rate of growth	%	+/-%
Sales Price starting figure	£	+/-%
Sales Price rate of growth	%	+/-%
Marketing Spend starting figure	£	+/-%
Marketing Spend rate of growth	%	+/-%
Payroll starting figure	£	+/-%
Payroll rate of growth	%	+/-%
Sales Lead Time	months	+/-%
Capital Expense	£	+/-%
Cost to produce starting figure	£	+/-%
Cost to produce rate of growth	%	+/-%
Creditor days	months	+/-%
Debtor days	months	+/-%
General Overheads starting figure	£	+/-%
General Overheads rate of growth	%	+/-%
Stock turn	months	+/-%
Interest rate	%	+/-%

Examine the Uncertainty in the financial projections; how wide is the spread? The Principals of a worthwhile business are inevitably going to be competent experienced managers who have a solid foundation for their business forecasts; if they are not, why are you interested? They will probably argue that they are being 'cautiously optimistic' and have 'realistic expectations' of major profit. Again, if not, why bother?

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 variation that we call Uncertainty. Looking at their assumptions you decide what realistically, in your opinion and once you have met them in theirs, could go wrong.

How does the model stand up with the Uncertainties factored in?

There are two significant practical implications of this potential variation. One is how these assumptions are important factors in the projections that create business values, and we look at them later in calculating the Reward side of Risk-Reward. 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. The value of the business changes. It is no longer something definite and predicted, hard and fast, arguably (and it will be argued…) written in stone; it becomes a range, diffuse, vague. And the precision of the range, whether it is +/- 100% or +/- 5%, is down to the competence of the management. Which is where the second practical implication comes in.

Are there any fundamental issues with the deliverability of the plan? The greater the potential variations in the assumptions, the better managed the business will need to be in order to succeed. Is the model realistic, in the sense that it is in line with their management ability and experience? Do you think they will be able to control the business and keep to their plan? Having a tool which enables investor and management to predict the weak links, the breaking points, and take action to reduce the impact is very valuable. What is the likelihood that you will be asked for more money? How good do the people have to be to run their Model without falling foul of the worse variations?

The next interesting insight to be gained from the plan concerns the entrepreneur's motivation. What are they proposing to pay themselves? What have they already put in? Cash? Sweat? Neither has any financial value at this juncture, but they do demonstrate commitment, and what the business represents to them. What, if anything, are they proposing as a valuation? This is covered later, but is nonetheless worth mentioning here.

What information do they propose to collect, what is measured, how, why, for whom, given to whom, with what result, repeatedly, consistently? Compliantly? Are there any questions arising? How do their plans compare with your experience?

Do they include historic/opening accounts and balance sheets? If not, why not? Are they also seeking any other sources of finance, and do you think they'll get them? Does the proposal create questions that there might be any difficulties in future funding rounds?

Cash issues are paramount. What are they going to use the funds for? What leverage will it bring? Can they clearly demonstrate how much they need? How reliable is their prediction? How long do they project they will take to break even? Can they be cash flow funded? To what milestones? Everything takes longer than planned, and the required funding should reflect this. By far the most important consideration is cash flow, cash flow and – er – cash flow. That's all. Oh, and did I mention cash flow?

How are you going to make money out of this? Despite what the original business plan might have said, an IPO (Initial Public Offering or flotation) is improbable: few businesses ever grow sufficiently to attract public investors. A trade sale is most common, followed by re-financing either by a larger Institution, or by the management specifically to effect a buy-out. On what basis are they proposing the company grows sufficiently to attract potential purchasers? High earnings? Capital Growth? If so, what are the likely multiples that will be achieved: 5 times? 10 times? Why would anyone want to buy it, and what characteristics would any potential purchaser need to have?

It is then time to sit and reflect, talk it through with colleagues and associates, take it to your Investor Club. Consider the risks, what can go wrong? Have they left any gaps in anything? Could you help fill those gaps, either personally or from your network, or could you recruit in sensibly? What can you add to the party? What will you have to commit for it to succeed? Of particular importance is to consider whether or not they will react positively to your involvement and advice, or will they resent your intrusion into their pet project?

Does the plan appeal to you? Why not read it again if in any doubt: it's often clearer second time. Do they demonstrate to your satisfaction that they understand the – your! – risks? Can you rationalise why it appeals to you? How does it fit in with anything else you're doing, going towards your own vision? Does it fit into your portfolio? Are there any other business synergies to add value?

Are you sold?

With each Model Risk factor, if the theory is OK it becomes a management issue, not something that's wrong with the model. So with experience, and only if you very much like the Vision and the People, getting the Model right should be down to the investor, and managing it should be amenable to mentoring.

Thus with Finance Risk, if the plan says there is enough working capital, capital expenditure is under control and cash flow is not an issue, any later problems will be management issues, not a problem with the Financial Model, and are amenable to your help.

Or with Operation Risk, if it is meant to be running smoothly and to plan, investment in equipment or people should not improve things so again any problems will be management issues….

Equally take Resource Risk: if the plan says that there's enough room, IT, bodies, storage etc with the capacity to function at the right level, it is difficult to see how, with your experience and input, this could be too far wrong.

Again with Sales and Markets Risk, would for example extra advertising spend make a difference? Or, simply, do they need training because they can't they sell?

Having thought through all the factors and implications of the Business Model, evaluate the risks in each of Sales and Marketing, Operations, Resources and Finances and make a judgement. Again give each risk factor a mark out of ten, and average them (add and divide by four) to arrive at a single figure for marks out of ten for Model Risk. Adjust it if upon reflection you think it isn't quite right. Obviously, with this approach if any single factor gets a very low mark, or if all factors get just about OK marks, the whole project is jeopardised, which is quite right.

Please keep this overall score: the 'Model' score contributes the third of the five 'risk' bits of 'risk-reward'

A low score on Model Risk is not necessarily a disaster or deal breaker: the Model is the aspect that is most likely to need attention, but it can be addressed once you've decided that it's worth doing in the first place. This is why Model Risk is averaged: it's amenable to constructive intervention.

So Model is not overly important, as if you like the People and their Vision you can help with the Model. That's one good place where you can add value.

Finally, consider the People and their Motivation; at this time it's only an initial guess – you'll need to meet them. How have they done? Have you seen enough to warrant a meeting? So long as none of your assessments come up too low, or with intervention couldn't be suitably improved, it's time for the next step:

Do you want to meet the Principals?

6.3.4 PEOPLE RISK

Before we examine the details, just think for a moment about the overall picture.

People are who will get the Vision from plan to reality, who convert the business model into bank balance. They are key. People must score very highly. And if they're not Motivated, you haven't got a hope. But bear in mind that, as we shall see later, Motivation has two aspects: their Motivation before they meet you, then their Motivation after the deal….

So far, all we've seen in the Business Plan is theory: maybe good, maybe less so. Even if it's the greatest, it's still theory. And People is the most important risk factor of all, the means by and through which all else becomes reality, or not.

Before you meet them, check into the people's background. What evidence can you find here that will help them drive the business forward? What's their track record? Do you think they could pull it off? Does it look as though they could actually make it happen, turn the plan into Bank Balance? Can they scale up satisfactorily, do you think they have thought it all through? Or are there any indications that when the going gets tough, they will abandon ship?

Alternatively, will anything change if it all does work? Be aware that in the process of growing to attract a purchaser, the business also becomes increasingly attractive as a lifestyle for the management. This can be the graveyard of Business Angel investing, and the cause of many a Boardroom battle.

You've decided to meet them because you like the plan: now you need to get them to try to explain it verbally from their viewpoint. Do they really understand what they're selling, which is a share of their business and not 'widgets'? To get across the right message you need to ensure that they really understand that you want to bring more to the table than your money and that you are seeking to back them and not their idea.

Do they rely on a formal presentation, or can they adlib? Get them to talk about and around what they're trying to do without too much interruption. This is your chance to let them make or break themselves.

Once they've had a good run through, test them: ask the awkward questions; question their assumptions; question their credentials. What's their secret ingredient, the one that will enable them to succeed in the teeth of the competition? And always listen closely to the answers: how flexible is their approach? Can they cope easily with challenge? Will they work closely with you, or insist on doing their own thing exclusively? Can they learn, or do they already know best?

Pick out something to ask them about, it doesn't matter what, and see if they understand the plan.

Even if they manage to persuade you that the plan is achievable, are they the people to achieve it? Will they be able to live up to the expectations they've built up in you?

6.3.4.1 People Risk: The entrepreneurial temperament

What are you looking for in an entrepreneur?

An entrepreneur could be 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. As Andrew Carnegie said, 'I pay less attention to what men say, and more to what they do'.

There are many different aspects of entrepreneurial flair, none wholly correct, certainly none without exception and not all of them good. Examples of things to seek out are: intuitive, able to see the big picture without losing attention to detail; competitive to a fault; innovative operating style; risk taker, thrill seeker, lover of novelty, unpredictable; impatient, impulsive, obsessive, short attention span, multitasker, charismatic, enthusiastic, passionate, inspirational; inductive, subjective, 'gut' decision maker; a need to prove something, to overcome insecurity or inferiority; perfectionist, striving for superiority, natural leader; able to cope in all environments, never phased; goal oriented; high self esteem, almost to arrogance.

And if he is to have any chance of attracting your money, one characteristic not to be overlooked is financial competence.

The attributes you are looking for in the entrepreneur are those suited to a leader: creating and growing a business, and fighting its corner against all comers, overcoming all the obstacles on the way to break even and self sufficiency. But being excellent at one function does not mean being excellent for others: starting, developing and growing a business is not the same as successfully running a mature one. It's a case of horses for courses: even the best management experience in a large corporation does not imply competence here. So what does make 'competent management'? What are the risk factors in People?

- **Character**
- **Experience**
- **Capability**
- **Knowledge**

all have to be present, particularly in the management but also in a balanced team.

6.3.4.2 People Risk: Character

The things to look for here are all fairly obvious positive character traits: honesty, strength of character, integrity, reliability, trustworthiness, ability to listen and learn, hard working, showing commitment and enthusiasm, likeable; someone who adds value, someone who can focus.

Be particularly sensitive to any suggestion that the entrepreneur might be cutting you in on a closed deal; is he a wheeler dealer, is he trying it on with anyone? Are there existing shareholders who are being forced to dilute, and what is his attitude to that? Is he suggesting questionable tactics regarding tax or domicile? Not that sensible planning is in any way negative, but what does this bode for the future?

Test your doubts and concerns about their plan and assumptions to see how he reacts. Is he meek or aggressive? Does he fight his corner persuasively, yet concede to better argument?

For men, one excellent suggestion is to get some feminine 'left brain' input and ask your wife/partner to meet them, as she is often more insightful and intuitive regarding character traits.

6.3.4.3 People Risk: Experience

A particularly useful insight into their story can be gained by asking for an early version of their plan. When was it first written, and what has happened since then, and why? How long have they been looking for funding? What's changed?

What is their track record, have they done it all before? Or have they done anything at all before, and if so how big was it and what happened? Ask for an early written plan for the previous business. Did they get anywhere near their forecasts?

6.3.4.4 People Risk: Capability

Can they actually get it done? Can they grow a business? Can they implement? Can they get others to do it too?

Or you just might have to introduce missing management competencies; at least you'll find out how accommodating they are. This is where battles are fought, and where your own experience and skill in management comes to the fore.

6.3.4.5 People Risk: Knowledge

What do they know, and how relevant is it? What expertise do they have regarding their chosen industry and technology? Are they known and respected by others in their field? Do they understand sales and marketing, and in detail who will be their customers? Do they understand accounts and finances? Are these enough for the business?

6.3.4.6 People Risk: The Team

You need to pull all of these thoughts together in a way that makes sense to you. Some find that psychological profiling is useful. Sceptics doubt its validity, but the model can be conceptually useful: it's worth thinking about where someone might fit comfortably in the schema. You don't have to do it in any formal sense, but simply become accustomed to making mental notes about the Principals and their teams. Put them under pressure, as that's often when the most valuable information comes out.

There are many methodologies used in profiling, and 'whatever works for you' is always the most useful. We find the Myers-Briggs Type Indicator intuitively helpful. It was designed to assist in identifying significant personality preferences, and is frequently used in the areas of training and leadership.

- Dominance (D) relates to control, power and assertiveness. People who score high in the intensity of their 'D' style factor are known as 'Drivers', and tend to be very active in dealing with problems and challenges, while low 'D' scores are people who want to do more research before committing to a decision.
- Influence (I) relates to social situations and communication. People with High I scores influence others through talking and activity and tend to be emotional, often making good salesmen. Those with Low I scores influence more by data and facts, and not with feelings.

- Steadiness (S) relates to patience, persistence, and thoughtfulness. High S persons are calm, relaxed, patient, possessive, predictable, deliberate, stable, consistent, and tend to be unemotional and poker faced. They tend just to get on with things. People with Low S scores are described as restless, demonstrative, impatient, eager, or even impulsive, and rarely see anything through to completion.
- Conscientiousness (C) relates to structure and organization. High C people are careful, cautious, exacting, neat, systematic, diplomatic, accurate, tactful and could be called 'Tidy-uppers'. Those with Low C scores challenge the rules and want independence and are described as 'Creatives', being self-willed, stubborn, opinionated, unsystematic, arbitrary, and careless with details.

The business needs a rounded team, people who can create the work, and those who can do it, sometimes repetitively under difficult conditions. Those who decide what to do, and those who need to be told what to do. People who can sell, and those who can count and record. It takes all sorts, literally. It is more than likely that there'll be some help or intervention needed.

Do they fundamentally understand all that is required? How is the team going to react to your involvement and advice? What's the chemistry, is there a personality clash? Could you work with them? Would you recruit or employ them?

The more competencies overall, the better the management and the greater is the risk tolerance of the other factors. When looking at the team, think 'rounded'.

Does the principal recognise the various role requirements of manager, creative and technician? Is he a leader, a manager, does he inspire you? If the entrepreneur has already brought in competent associates, it means he has proven he has a certain charisma and can sell the idea and motivate others, as competent team members will already have made their own assessment of the project viability.

Another useful way to look at the team is to draw up a functional organogram. With the team, analyse the positions in the structure that need to exist. Write down a summary of each job description, allocating personalities to each role and identifying all the characteristics of an ideal candidate. Can the team identify all the roles, and how many are currently competently filled? Where are the gaps?

Now it's time to make your judgment on People Risk. After considered reflection, put a figure down for each competence, Character, Experience, Capability and Knowledge, as a mark out of ten. Multiply the numbers together to arrive at an overall judgement, changing it if you think it not quite right to arrive at a 'marks out of ten' for People Risk.

Obviously, 'People' is the most important aspect of risk assessment: all else hinges on it. That is why we multiply the individual factors together, because they are compounded.

It is essential to have a high People score. It must be at least a seven out of ten. If you multiply four fractions out of ten together, how do you get at least a seven out of ten? You MUST HAVE at least one ten with three nines, or two tens with a nine and an eight, or three tens with just one seven. And the score for Character must be one of the tens.

Character Risk: Are they honest, or moonlighting for the competition? Are they likely to run off with the secretary? On Character, you need a ten out of ten. No question, no debate.

Experience Risk: you can't buy experience, you have to go through things and learn from them to get it. But if the entrepreneur has high Character, high Motivation and is Capable of learning, you can get away with a seven for Experience if you're prepared to put time in mentoring.

Capability Risk: 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. Capability must score at least a nine.

Knowledge Risk: Other than in matters of pure business, they probably know more about their technology and model than you do. If there are any areas that they lack, tell them to acquire it. So here again, if the entrepreneur has excellent scores for Character Motivation and Capability, you can accept a seven for Knowledge.

Please keep your overall score: the 'People' score contributes the fourth of the five 'risk' bits of 'risk-reward'.

If you have decided that the business is one you would like in your portfolio, and that these are people you could work with now that you have met them, it's time to review the Vision score you previously allocated. In light of their enthusiasm and understanding of what's involved, make an appropriate alteration.

Now you need to begin to understand their Motivation.

6.3.5 MOTIVATION RISK

Are you ideally looking for an opportunity where highly competent management are driving forward a low risk business? Don't expect too much of a rough ride, or phenomenal returns. And don't expect to see many opportunities like that either!

There are several aspects to an individual's motivation that need to be analysed and thought through, but principally you need to distinguish motivation before the deal from that after the deal. And having met and understood them, then make a judgement about what the latter will be if you can.

Before the deal, examine what they have already sacrificed for the Business. Is it their 'baby'? Will they be able to let some of it go? Do some personal digging by getting up very early and taking a quiet look at who arrives at their office when. If you phone out of hours, who answers? Are the entrepreneurs' personal and family goals in line with the business's aspirations?

Do they come across as exit or lifestyle oriented? Do they come across as greedy or needy for higher salary and benefits than you feel justified at this stage of the business? They still have to live, but they can take benefits from the cash profits at the same time as you: when they come in. What do they stand to lose if they fail to deliver? It is very important that the entrepreneur's commitment to success is underpinned by fear of failure: whatever their absolute contribution, it should be relatively substantial and they should have nowhere else to run.

Be aware that a frequent issue for fundseekers is the fear that an investor is wishing to take control of their 'baby'. How much of what will belong to whom? Do they feel they get to keep enough, or maybe you think they might even keep too much if they become insufficiently driven? Who is going to run the company? Who is making money for whom?

A final consideration when considering motivation is a phenomenon called 'Risk homeostasis'. This implies that an individual has an inbuilt level of acceptable risk which feels comfortable, and this varies between individuals. When the level of acceptable risk in one part of the individual's life changes, this tends to mean that there will be a corresponding and inverse change in acceptable risk elsewhere. This clearly has implications for deal structure and how it might affect 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.

After the deal, will the critical objectives of the team remain aligned with those of the Investor? Negotiating and finalising the terms of any deal will have a major influence on how you assess the motivation of the Principals, so the final judgment has to be made later, but for now you still have to crystallise your thoughts. Make an assessment of the principal's financial commitment and motivation as seen and on the deal terms you would like, and score Motivation out of ten. You may well have to review this after you've done the deal, but it's the best you can do for now.

If it's easier to visualise the 'before the deal' figure separately from the 'after' figure, try scoring them individually and multiply them together. Motivation just has to be high.

Please keep this score: the 'Motivation' score contributes the fifth and last bit of the five 'risk' bits of 'risk-reward'. Multiply all the risks together to get at a 'number out of 100,000' and simplify it to arrive at your final score for Risk: '1/r'.

The first meeting is finished. You should sum up, and give the entrepreneur your 'score'. If it's not for you, tell them now. If it might be for you, tell them what happens next, and by when. Agree the date of the next meeting, and what they will need to have done by then to keep your interest.

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Raising Business Finance for Entrepreneurs Part II