How to Convince Investors

August 2013When people hurt themselves lifting heavy things, it's usually  
because they try to lift with their back. The right way to lift  
heavy things is to let your legs do the work. Inexperienced founders  
make the same mistake when trying to convince investors. They try  
to convince with their pitch. Most would be better off if they let  
their startup do the work — if they started by understanding why  
their startup is worth investing in, then simply explained this  
well to investors.Investors are looking for startups that will be very successful.  
But that test is not as simple as it sounds. In startups, as in a  
lot of other domains, the distribution of outcomes follows a power  
law, but in startups the curve is startlingly steep. The big  
successes are so big they   
dwarf the rest. And since there are only  
a handful each year (the conventional wisdom is 15), investors treat  
"big success" as if it were binary. Most are interested in you if  
you seem like you have a chance, however small, of being one of the  
15 big successes, and otherwise not.  
[1](There are a handful of angels who'd be interested in a company  
with a high probability of being moderately successful. But angel  
investors like big successes too.)How do you seem like you'll be one of the big successes? You need  
three things: formidable founders, a promising market, and (usually)  
some evidence of success so far.FormidableThe most important ingredient is formidable founders. Most investors  
decide in the first few minutes whether you seem like a winner or  
a loser, and once their opinion is set it's hard to change. [2]  
Every startup has reasons both to invest and not to invest. If  
investors think you're a winner they focus on the former, and if  
not they focus on the latter. For example, it might be a rich  
market, but with a slow sales cycle. If investors are impressed  
with you as founders, they say they want to invest because it's a  
rich market, and if not, they say they can't invest because of the  
slow sales cycle.They're not necessarily trying to mislead you. Most investors are  
genuinely unclear in their own minds why they like or dislike  
startups. If you seem like a winner, they'll like your idea more.  
But don't be too smug about this weakness of theirs, because you  
have it too; almost everyone does.There is a role for ideas of course. They're fuel for the fire  
that starts with liking the founders. Once investors like you,  
you'll see them reaching for ideas: they'll be saying "yes, and you  
could also do x." (Whereas when they don't like you, they'll be  
saying "but what about y?")But the foundation of convincing investors is to seem formidable,  
and since this isn't a word most people use in conversation much,  
I should explain what it means. A formidable person is one who  
seems like they'll get what they want, regardless of whatever  
obstacles are in the way. Formidable is close to confident, except  
that someone could be confident and mistaken. Formidable is roughly  
justifiably confident.There are a handful of people who are really good at seeming  
formidable — some because they actually are very formidable and  
just let it show, and others because they are more or less con  
artists.  
[3]  
But most founders, including many who will go on  
to start very successful companies, are not that good at seeming  
formidable the first time they try fundraising. What should they  
do?  
[4]What they should not do is try to imitate the swagger of more  
experienced founders. Investors are not always that good at judging  
technology, but they're good at judging confidence. If you try to  
act like something you're not, you'll just end up in an uncanny  
valley. You'll depart from sincere, but never arrive at convincing.TruthThe way to seem most formidable as an inexperienced founder is to  
stick to the truth. How formidable you seem isn't a constant. It  
varies depending on what you're saying. Most people can seem  
confident when they're saying "one plus one is two," because they  
know it's true. The most diffident person would be puzzled and  
even slightly contemptuous if they told a VC "one plus one is two"  
and the VC reacted with skepticism. The magic ability of people  
who are good at seeming formidable is that they can do this with  
the sentence "we're going to make a billion dollars a year." But  
you can do the same, if not with that sentence with some fairly  
impressive ones, so long as you convince yourself first.That's the secret. Convince yourself that your startup is worth  
investing in, and then when you explain this to investors they'll  
believe you. And by convince yourself, I don't mean play mind games  
with yourself to boost your confidence. I mean truly evaluate  
whether your startup is worth investing in. If it isn't, don't try  
to raise money.  
[5]  
But if it is, you'll be telling the truth  
when you tell investors it's worth investing in, and they'll sense  
that. You don't have to be a smooth presenter if you understand  
something well and tell the truth about it.To evaluate whether your startup is worth investing in, you have  
to be a domain expert. If you're not a domain expert, you can be  
as convinced as you like about your idea, and it will seem to  
investors no more than an instance of the Dunning-Kruger effect.  
Which in fact it will usually be. And investors can tell fairly  
quickly whether you're a domain expert by how well you answer their  
questions. Know everything about your market.  
[6]Why do founders persist in trying to convince investors of things  
they're not convinced of themselves? Partly because we've all been  
trained to.When my friends Robert Morris and Trevor Blackwell were in grad  
school, one of their fellow students was on the receiving end of a  
question from their faculty advisor that we still quote today. When  
the unfortunate fellow got to his last slide, the professor burst  
out:  
  
 Which one of these conclusions do you actually believe?  
  
One of the artifacts of the way schools are organized is that we  
all get trained to talk even when we have nothing to say. If you  
have a ten page paper due, then ten pages you must write, even if  
you only have one page of ideas. Even if you have no ideas. You  
have to produce something. And all too many startups go into  
fundraising in the same spirit. When they think it's time to raise  
money, they try gamely to make the best case they can for their  
startup. Most never think of pausing beforehand to ask whether  
what they're saying is actually convincing, because they've all  
been trained to treat the need to present as a given — as an area  
of fixed size, over which however much truth they have must needs  
be spread, however thinly.The time to raise money is not when you need it, or when you reach  
some artificial deadline like a Demo Day. It's when you can convince  
investors, and not before.   
[7]And unless you're a good con artist, you'll never convince investors  
if you're not convinced yourself. They're far better at detecting  
bullshit than you are at producing it, even if you're producing it  
unknowingly. If you try to convince investors before you've convinced  
yourself, you'll be wasting both your time.But pausing first to convince yourself will do more than save you  
from wasting your time. It will force you to organize your thoughts.  
To convince yourself that your startup is worth investing in, you'll  
have to figure out why it's worth investing in. And if you can  
do that you'll end up with more than added confidence. You'll also  
have a provisional roadmap of how to succeed.MarketNotice I've been careful to talk about whether a startup is worth  
investing in, rather than whether it's going to succeed. No one  
knows whether a startup is going to succeed. And it's a good thing  
for investors that this is so, because if you could know in advance  
whether a startup would succeed, the stock price would already be  
the future price, and there would be no room for investors to make  
money. Startup investors know that every investment is a bet, and  
against pretty long odds.So to prove you're worth investing in, you don't have to prove  
you're going to succeed, just that you're a sufficiently good bet.  
What makes a startup a sufficiently good bet? In addition to  
formidable founders, you need a plausible path to owning a big piece  
of a big market. Founders think of startups as ideas, but investors  
think of them as markets. If there are x number of customers who'd  
pay an average of $y per year for what you're making, then the total  
addressable market, or TAM, of your company is $xy. Investors don't  
expect you to collect all that money, but it's an upper bound on  
how big you can get.Your target market has to be big, and it also has to be capturable  
by you. But the market doesn't have to be big yet, nor do you  
necessarily have to be in it yet. Indeed, it's often better to  
start in a small market that will either turn into a big one or  
from which you can move into a big one. There just has to be some  
plausible sequence of hops that leads to dominating a big market a  
few years down the line.The standard of plausibility varies dramatically depending on the  
age of the startup. A three month old company at Demo Day only  
needs to be a promising experiment that's worth funding to see how  
it turns out. Whereas a two year old company raising a series A  
round needs to be able to show the experiment worked.   
[8]But every company that gets really big is "lucky" in the sense that  
their growth is due mostly to some external wave they're riding,  
so to make a convincing case for becoming huge, you have to identify  
some specific trend you'll benefit from. Usually you can find this  
by asking "why now?" If this is such a great idea, why hasn't  
someone else already done it? Ideally the answer is that it only  
recently became a good idea, because something changed, and no one  
else has noticed yet.Microsoft for example was not going to grow huge selling Basic  
interpreters. But by starting there they were perfectly poised to  
expand up the stack of microcomputer software as microcomputers  
grew powerful enough to support one. And microcomputers turned out  
to be a really huge wave, bigger than even the most optimistic  
observers would have predicted in 1975.But while Microsoft did really well and there is thus a temptation  
to think they would have seemed a great bet a few months in, they  
probably didn't. Good, but not great. No company, however successful,  
ever looks more than a pretty good bet a few months in. Microcomputers  
turned out to be a big deal, and Microsoft both executed well and  
got lucky. But it was by no means obvious that this was how things  
would play out. Plenty of companies seem as good a bet a few months  
in. I don't know about startups in general, but at least half the  
startups we fund could make as good a case as Microsoft could have  
for being on a path to dominating a large market. And who can  
reasonably expect more of a startup than that?RejectionIf you can make as good a case as Microsoft could have, will you  
convince investors? Not always. A lot of VCs would have rejected  
Microsoft.  
[9]  
Certainly some rejected Google. And getting  
rejected will put you in a slightly awkward position, because as  
you'll see when you start fundraising, the most common question  
you'll get from investors will be "who else is investing?" What do  
you say if you've been fundraising for a while and no one has  
committed yet?   
[10]The people who are really good at acting formidable often solve  
this problem by giving investors the impression that while no  
investors have committed yet, several are about to. This is arguably  
a permissible tactic. It's slightly dickish of investors to care  
more about who else is investing than any other aspect of your  
startup, and misleading them about how far along you are with other  
investors seems the complementary countermove. It's arguably an  
instance of scamming a scammer. But I don't recommend this approach  
to most founders, because most founders wouldn't be able to carry  
it off. This is the single most common lie told to investors, and  
you have to be really good at lying to tell members of some profession  
the most common lie they're told.If you're not a master of negotiation (and perhaps even if you are)  
the best solution is to tackle the problem head-on, and to explain  
why investors have turned you down and why they're mistaken. If  
you know you're on the right track, then you also know why investors  
were wrong to reject you. Experienced investors are well aware that  
the best ideas are also the scariest. They all know about the VCs  
who rejected Google. If instead of seeming evasive and ashamed  
about having been turned down (and thereby implicitly agreeing with  
the verdict) you talk candidly about what scared investors about  
you, you'll seem more confident, which they like, and you'll probably  
also do a better job of presenting that aspect of your startup. At  
the very least, that worry will now be out in the open instead of  
being a gotcha left to be discovered by the investors you're currently  
talking to, who will be proud of and thus attached to their discovery.  
[11]This strategy will work best with the best investors, who are both  
hard to bluff and who already believe most other investors are  
conventional-minded drones doomed always to miss the big outliers.  
Raising money is not like applying to college, where you can assume  
that if you can get into MIT, you can also get into Foobar State.  
Because the best investors are much smarter than the rest, and the  
best startup ideas look initially like   
bad ideas, it's not uncommon  
for a startup to be rejected by all the VCs except the best ones.  
That's what happened to Dropbox. Y Combinator started in Boston,  
and for the first 3 years we ran alternating batches in Boston and  
Silicon Valley. Because Boston investors were so few and so timid,  
we used to ship Boston batches out for a second Demo Day in Silicon  
Valley. Dropbox was part of a Boston batch, which means all those  
Boston investors got the first look at Dropbox, and none of them  
closed the deal. Yet another backup and syncing thing, they all  
thought. A couple weeks later, Dropbox raised a series A round  
from Sequoia.  
[12]DifferentNot understanding that investors view investments as bets combines  
with the ten page paper mentality to prevent founders from even  
considering the possibility of being certain of what they're saying.  
They think they're trying to convince investors of something very  
uncertain — that their startup will be huge — and convincing anyone  
of something like that must obviously entail some wild feat of  
salesmanship. But in fact when you raise money you're trying to  
convince investors of something so much less speculative — whether  
the company has all the elements of a good bet — that you can  
approach the problem in a qualitatively different way. You can  
convince yourself, then convince them.And when you convince them, use the same matter-of-fact language  
you used to convince yourself. You wouldn't use vague, grandiose  
marketing-speak among yourselves. Don't use it with investors  
either. It not only doesn't work on them, but seems a mark of  
incompetence. Just be concise. Many investors explicitly use that  
as a test, reasoning (correctly) that if you can't explain your  
plans concisely, you don't really understand them. But even investors  
who don't have a rule about this will be bored and frustrated by  
unclear explanations.  
[13]So here's the recipe for impressing investors when you're not already  
good at seeming formidable:  
  
 Make something worth investing in. Understand why it's worth investing in. Explain that clearly to investors.  
  
If you're saying something you know is true, you'll seem confident  
when you're saying it. Conversely, never let pitching draw you  
into bullshitting. As long as you stay on the territory of truth,  
you're strong. Make the truth good, then just tell it.Notes[1]  
There's no reason to believe this number is a constant. In  
fact it's our explicit goal at Y Combinator to increase it, by  
encouraging people to start startups who otherwise wouldn't have.[2]  
Or more precisely, investors decide whether you're a loser  
or possibly a winner. If you seem like a winner, they may then,  
depending on how much you're raising, have several more meetings  
with you to test whether that initial impression holds up.But if you seem like a loser they're done, at least for the next  
year or so. And when they decide you're a loser they usually decide  
in way less than the 50 minutes they may have allotted for the first  
meeting. Which explains the astonished stories one always hears  
about VC inattentiveness. How could these people make investment  
decisions well when they're checking their messages during startups'  
presentations? The solution to that mystery is that they've already  
made the decision.[3]  
The two are not mutually exclusive. There are people who are  
both genuinely formidable, and also really good at acting that way.[4]  
How can people who will go on to create giant companies not  
seem formidable early on? I think the main reason is that their  
experience so far has trained them to keep their wings folded, as  
it were. Family, school, and jobs encourage cooperation, not  
conquest. And it's just as well they do, because even being Genghis  
Khan is probably 99% cooperation. But the result is that most  
people emerge from the tube of their upbringing in their early  
twenties compressed into the shape of the tube. Some find they  
have wings and start to spread them. But this takes a few years.  
In the beginning even they don't know yet what they're capable of.[5]  
In fact, change what you're doing. You're investing your own  
time in your startup. If you're not convinced that what you're  
working on is a sufficiently good bet, why are you even working on  
that?[6]  
When investors ask you a question you don't know the answer  
to, the best response is neither to bluff nor give up, but instead  
to explain how you'd figure out the answer. If you can work out a  
preliminary answer on the spot, so much the better, but explain  
that's what you're doing.[7]  
At YC we try to ensure startups are ready to raise money on  
Demo Day by encouraging them to ignore investors and instead focus  
on their companies till about a week before. That way most reach  
the stage where they're sufficiently convincing well before Demo  
Day. But not all do, so we also give any startup that wants to the  
option of deferring to a later Demo Day.[8]  
Founders are often surprised by how much harder it is to raise  
the next round. There is a qualitative difference in investors'  
attitudes. It's like the difference between being judged as a kid  
and as an adult. The next time you raise money, it's not enough  
to be promising. You have to be delivering results.So although it works well to show growth graphs at either stage,  
investors treat them differently. At three months, a growth graph  
is mostly evidence that the founders are effective. At two years,  
it has to be evidence of a promising market and a company tuned to  
exploit it.[9]  
By this I mean that if the present day equivalent of the 3  
month old Microsoft presented at a Demo Day, there would be investors  
who turned them down. Microsoft itself didn't raise outside money,  
and indeed the venture business barely existed when they got started  
in 1975.[10]  
The best investors rarely care who else is investing, but  
mediocre investors almost all do. So you can use this question as  
a test of investor quality.[11]  
To use this technique, you'll have to find out why investors  
who rejected you did so, or at least what they claim was the reason.  
That may require asking, because investors don't always volunteer  
a lot of detail. Make it clear when you ask that you're not trying  
to dispute their decision — just that if there is some weakness in  
your plans, you need to know about it. You won't always get a real  
reason out of them, but you should at least try.[12]  
Dropbox wasn't rejected by all the East Coast VCs. There was  
one firm that wanted to invest but tried to lowball them.[13]  
Alfred Lin points out that it's doubly important for the  
explanation of a startup to be clear and concise, because it has  
to convince at one remove: it has to work not just on the partner  
you talk to, but when that partner re-tells it to colleagues.We consciously optimize for this at YC. When we work with founders  
create a Demo Day pitch, the last step is to imagine how an investor  
would sell it to colleagues.  
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