Seed Stage Investing - Standard Set of Questions

I am always impressed with the enthusiasm and drive that accompany entrepreneurs and their start-ups. The lifestyle of an entrepreneur isn't for everyone, but for those who are truly inspired to make a difference in their industry, and to profit from being in the eye of the storm, there's nothing better than starting and launching a new company. I like to remind investment candidates that their chances of surviving are much, much better than winning the lottery, and I encourage them to ignore the naysayers and well-wishers who would happily and innocently dissuade them from pursuing life in a start-up. Keep the flame alive and stay focused on the end-goal! But, as with all things in life, there are stresses with new companies – never enough capital, never enough time, never enough resources. Invariably, the sparkle and appeal from the new company can begin to wane as the founders are forced to balance fund-raising with running their business, and I have seem more than a few founders who end up working two jobs, sometimes without getting paid. And yes, I once wore those shoes.

It's usually in the quest for early-stage capital that I meet the investment candidate. If the pitch sounds interesting, I will ask for a business plan - sometimes they have a powerpoint presentation, sometimes it's a full-fledged business plan, and sometimes I receive an email with the summary of challenges and opportunities. There is no shortage of internet articles to guide entrepreneurs in how to prepare a business plan, and yet, it is usually a step in the process that is neglected. I have learned to look beyond the formatting issues, and delve into a quick test to evaluate the opportunity – normally it will be about 20-30 minutes of discussion, and honestly, if it doesn't go well during that call, there is no second chance. So, in an effort to provide some concise guidance on what investors (like me) are looking for, I am offering a list of "standard questions" for which an entrepreneur should be able to easily answer.

- Who?
    - Who are the founders?
- What?
    - What is the opportunity? (Elevator Pitch)
- Why?
    - Why do you need money? How much of your own have you put in?
- How?
    - How will investors profit from investing with you?

These aren't the complete set of due-diligence matters, and it is possible that an entrepreneur can successfully answer these screening questions and fail in the later stages of investment due diligence. But, these are the "gatekeeper" questions. One must be able to quickly and convincingly respond to these basic questions before moving on to the next step. Let's dig one step deeper into these standard questions.

Who?

In the connected world, it is not that difficult for any entrepreneur to work through their spheres of influence to find someone who knows someone, who may know someone, who knows the investor. The six-degrees of separation have been empirically demonstrated with facebook, linkedin and the other cast of networking tools. Things weren't always that easy! It used to be that we had to work the phones and rolodexes to find out these linkages. Or worse, those in need of funding had to rely on a series of paid agents/brokers to be introducers – there's nothing wrong with these agents, but they're better for later stage investing, not seed stage. It would be worthwhile for any entrepreneur to do the basic personnel research before contacting a prospective investor! And, without a doubt, the research should be done before any first meeting, because one can be assured that the investor will have done research beforehand, and information asymmetry is usually sub-optimal for the weaker hand.

Given that the first question is going to be "Who the heck are you?" one should be in tune with the concept of an appealing online profile. Hopefully, in addition to finding some mutual references via a social network scan, the entrepreneur has also created an online presence that goes far beyond the occasional photo with beer in hand on a cruise ship, bar, etc. posing for YouTube or other random photo opp. The new generation of entrepreneurs will benefit by investing time and energy to create a clean and inspiring online presence. In fact, my teenage son recently explained that it is a right of passage for college-bound juniors in high school to create fictional or new facebook ids so that the wilder side of high school life is not exposed for admissions officers! That can be the topic of a different article…

What?

I was recently in a meeting where the entrepreneur froze – just clammed up, stalled and couldn't speak. He started looking around for assistance, and it was uncomfortable, but we were able to work through the delay. These things can and do happen, but the risk of being unable to articulate that basic pitch is a risk that can be managed to near-zero. Some people enjoy public speaking, some people hate it – to each his/her own. I truly enjoy public speaking, but it wasn't always that way. Like everyone else, I was nervous the first few times that I had to get up in front of a large group. The only cure for this malady is rehearsal. Not the kind of rehearsal where you mentally envision your speaking! You need to stand up, film it, or at least look at yourself in the mirror and critique yourself while you practice the pitch. Again, things weren't always this easy. A video camera used to be expensive, now it comes on a smartphone. If you are making pitches and you haven't filmed yourself and evaluated a mock run-through, you're doing yourself and your business an injustice.

The second worst offense is to over think things. Early stage investors don't need all the nitty gritty – just the "big picture" will suffice. Yes, I expect that an entrepreneur can drill down into all the details, and I may probe to see how deep they can go, but it is not necessary to lead-in with all the details. We're looking for something that's commonly called the cocktail napkin sketch or the elevator pitch – those metaphors are appropriately brief! Make sure that the opportunity has been condensed down to its basics. Then, rehearse telling the story 100 times, in front of a mirror or with a video camera.

You may find others who are willing to help – try posting the final video product of your pitch on your PERSONAL facebook page (not for the whole world to see), and ask your friends to evaluate and give guidance. Use modern social technology to get the most benefit of preparation for your new idea! There have been some recent advances in moving towards "crowd sourcing" of investment ideas, so it's likely that this type of preparation and social media usage will become the "new norm" for early stage investing http://www.crainsnewyork.com/article/20120111/SMALLBIZ/120119980 .

Why?

Technically, this goes hand-in-hand with the elevator pitch, but I have listed it as a separate item for purposes of explaining some basic facts.

First, one does not have to be rich to start up a company, but if you are rich (or your parents are rich), and you haven't put in your own capital as the first investor, it will raise some eyebrows and will count as strike one (and strike two). Granted, there are always unique situations, but rest assured that without your own investment "on the line", things will be more challenging – not impossible. If your first investment was not your own (or family's) funds, it will be a requirement to explain the situation. Needless to say that it would be much smoother to confirm that, yes, you have significant stake invested in this idea and therefore have a lot to gain as well as a lot to lose. Risk can sharpen the mind, and we would all rather spend time focusing on the business idea, not focusing on why you have no skin in the game.

Second, if you are looking for money to pay your salary only, the discussion is not going to get very far. More than once I have come across a business plan where an entrepreneur is recording a salary expense for themselves at a level which corresponds to their most recent w-2. And, invariably, I have to explain that investments are for growing businesses, not supporting lifestyles - that's why a start-up isn't for everyone.

If you're an entrepreneur who formerly was successful in business, there is near certainty that you will exchange some current income for sweat equity. Run the numbers first, know your budget requirements, and expect that your salary will meet the basic needs, everything else will be performance-based.

How?

Investors are selfish. They want to make money off of your work - it's true. In an ideal circumstance, the investor will bring money and contacts to the table. If that's the case, the investor is hoping to profit from both contributions, so take some time to fix your pitch to address their needs. If you get this far in the discussion, it's all about their benefit, not yours. Be clear on the economic profile of the investment, and be prepared to negotiate in good faith.

It is usually during the "numbers part" of the meeting where the entrepreneur will get a glimpse into the future relationship with the investor. If you see that there is friction, make a note of it. If you're lucky enough to get a handful of willing investors, choose the ones where you found the least amount of friction (assuming the other value-adds such as contacts were comparable). Personal chemistry is important, there's no science to the interactions – it's one of those cases where the entrepreneur needs to trust their "gut instinct".

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