How Angel Investors Read Business Plans

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This is an awkward paper to write. This is the paper in which I tell some entrepreneurs, “Your kid is ugly.”

I’ve written another paper about how angel investors work in groups and review business plans, and about the criteria they use for investment. That’s a useful paper for those without experience working with angel groups. This paper focuses on how investors make decisions.

Remember that businesses are different from kids. Your kid is your kid and you’re going to invest in him. Your business is different. If you have designed your business wrong, you can change it. You can either abandon the old venture entirely or you can alter your approach to give your business better prospects of success.

I’m going to talk about some things you don’t usually hear. People who review ventures try to be as nice as they can to those who have submitted the plan. They’ll give you some feedback, but they’ll rarely speak their minds completely. Why? These are some reasons why you don’t hear the unvarnished truth:

- The reader doesn’t want to upset people who may have friends with good businesses looking for funding. Deal flow is important and if you’re seen as a negative person, entrepreneurs may go elsewhere.
- Another reason that people don’t say the tough things is that angel investors believe in entrepreneurs; angel investors hope that many small companies can grow to make lots of money for everyone involved with them. Angels are enthusiastic about entrepreneurs and want them to succeed, if not with this particular venture, maybe with one in the future.
- If an investor gives the entrepreneur detailed feedback, it’s entirely possible that the response will be an argument. Another possible response can be a request from the entrepreneur for the investor to read more documents, or have a long discussion. In short, there’s a chance that by giving straight feedback, the investor will have to spend more time on a plan he knows he doesn’t like and isn’t going to like, and he may get yelled at in addition.

Because everyone wants to be nice, you, the entrepreneur, don’t hear what’s said in the review committees and closed-door meetings. And you ought to know. It doesn’t seem fair that you shouldn’t get a glimpse of how investors think if understanding that can help you to refine your business and have a better chance at success. But I warn you, it’s going to sound as though I’m saying, “Your kid is ugly.”

Some quick credentials for me:

- I’ve worked inside entrepreneurial companies all of my career, and been a director of or adviser to others; I’ve done every job in growth companies, so

I've seen what works and what doesn't; I work with young, growing companies all the time

- I've helped raise money 7 times for companies I was inside of or associated with
- I've been involved in buying and selling companies, several times to public companies; at one time I was a licensed broker/dealer
- I'm on the selection/review committees for two angel groups
- I was on the Board of the International MIT Enterprise Forum (where I was board chairman)and the MIT Enterprise Forum of Cambridge Executive Board; I've seen a lot of business plans presented there
- I see a lot of young companies as Co-Chair of MIT's Venture Mentoring Service, and I see what they need to do to raise money
- Altogether, I probably see 200 business plans or executive summaries or young companies every year.

Investors and Risk

You have to look at things from the investor's point of view. You, the entrepreneur, see your business as the wonderful and unique thing you're going to make succeed. An angel investor looks at a lot of business opportunities, and has to pick the one, two, or three which are the very best to invest in; she then hopes that she and they will be successful. The 97% an investor doesn't pursue may be fine, but they don't appear to be quite as good as the 3% that got money.

You should understand how investors read plans, look at the investment decision, or, what's more relevant, make the decision to spend serious time looking into a plan.

When an investor is looking at business plans and knows that he's going to spend very little time on most of them, his going-in assumption must be, "There's enough wrong with this business plan that I don't want to bother spending more time on it." That has to be his assumption. He can't assume the opposite, that all plans are good until proven otherwise, because:

- he'll be swamped and never get through the stack of opportunities, and
- invest all his money in bad plans.

(Note: The terms "bad plan" and "good plan" are shorthand for "plan with a low probability of succeeding" and "dynamite, exciting plan for a company which will likely succeed.")

Thus the investor assumes that he won't like any individual plan. Reading the executive summary is the one chance the plan's author has to change this negative assumption. (And investors are pleased if they can find the evidence that this is in fact a really good plan. But mostly they don't.)

When reading plans, the investor can make one of two possible kinds of errors:

- Type I error, which my edition of the Handbook of Probability and Statistics defines as "…rejecting a true hypothesis."
- Type II error, defined as "…accepting a false hypothesis."

You see where I'm going.

- If the investor makes a Type I error, he spends time (or even money) on a bad plan, rejecting his true hypothesis that it was a bad plan.
- If the investor makes a Type II error, he skips over a good plan, accepting his false hypothesis that it's bad.

Here's the problem for the entrepreneur: the investor sees a whole lot of plans. It's not very costly to the investor if he misses a good one. That's opportunity cost rather than real cost; the investor misses money he might have made. That's too bad, but we all do it. However, it can be very costly to the investor if he invests a lot of time or worse, time and money, on a plan which won't succeed. In statistical terms, Type I error is much more costly for an investor than Type II error.

Another statistical fact: if you reduce your chances of making one type of error, you increase the chances of making the other type. You can't get rid of both types, so you decide which one costs you less and accept more of that type. Therefore, an investor who sees lots of plans will lean toward rejecting good ones (Type II error) rather than spending time and money on plans which aren't likely to succeed (Type I error.)

Looking at Business Plans

If you're an experienced investor, you'll find a way to implement the logic described above. You'll look for ways to quickly confirm your hypothesis that there's something wrong with the plan you're reading. It's in your interest to come up with ways of categorizing (and therefore quickly rejecting) the bulk of plans.

The above may sound overly rational and cold-blooded. It's really a way, and maybe the only way, for the investor to allocate the scarce resource of his time.

In non-theoretical and practical terms, when you see a lot of business plans, you have to develop an internal coding system which lets you bring order to the process and cut through the large mass of information you're facing. The first fifty plans you see are all different. You begin to build categories after that, and when you've seen hundreds or thousands, you develop some strong opinions about which ones to look at seriously.

Below are some categories used to accept the hypothesis that a plan is bad. If it fits one of these categories, the investor feels fine rejecting it.

These categories include:

- Me too companies – you see these a lot in software and a certain number in retail. Someone has an idea for a product in a well-defined and stable market, where the major players all have big investments in their market share. A small company claims to have a better idea or product and wants investment to compete with the big guys. There are three problems with this kind of company:
  - First, it's hard to pick a winner among the large percentage of companies like this which will fail
  - Second, in order to compete successfully, a venture will need a lot of money to compete and the early investors are likely to be diluted down to nothing
  - Third, an investor seeing a venture which intends to enter a well-established field on small money will always wonder the following: Are these folks experienced realists who can make it work, or techies who have no idea what it takes to build a market for a new company? And most investors assume the latter until proven wrong.
- Slightly better – there are some ventures in which the entrepreneurs have designed a product that's slightly better than the market-leading products. It's not uncommon for the company to be surprised that there's no investor support for their business. Left out of the equation by the entrepreneurs are the costs of getting the story heard and the costs to the user of replacing the existing satisfactory product with one marginally better. Plus all of the costs of building a company large to compete and to match the existing vendors on service, support, and all the other aspects of selling and serving customers.
- Too many moving parts – these are ventures which may in fact have a much better idea, but require one or more major industries to change the way they do business. It is unlikely, for example, that a young firm will get retail stores to trade in all their point-of-sale systems, credit card companies to add a new process, cellular carriers to change their software, all because the small firm has a good idea.
- Bad market – there are some markets which just don't appeal. Investors don't want to go near them. For example, my experience leads me to have little or no interest in young ventures which sell to school districts, architects, doctors, or dentists, or plan to sell utility software to enterprises.
- Noisy space – there are some market spaces which are so noisy that it's really hard for a small investor to figure out which venture will win. It's obvious that several firms will win, but almost impossible to tell which ones. Examples of this space at the time of writing this paper include
  - What kind of company will make money in the RFID space?
  - Who will make money on Sarbanes-Oxley? Product firm? Service firm?
  - There's a lot of concern about privacy and security around the web and today's and tomorrow's increasing interconnectivity.   Who will win in this space?

- No upside – sometimes an investor sees a perfectly reasonable plan for a perfectly reasonable company which doesn't appeal because some combination of factors makes it likely that the company will never grow very much. It may make decent profits and do okay, but it doesn't have a chance ever to be what a venture capitalist friend of mine calls an "elephant."
- Incomplete team – often you'll see a venture with a small team which can develop the product or service but doesn't have anyone on board who can sell it and no one who's built a company. An investor may think that the company is off to a good start with an incomplete team, but usually the view is that the venture can't even be looked at until somebody is involved who understands finding markets and executing.
- No strategy – sometimes an investor sees a venture which has some good intellectual property around some neat technology, but the founders don't seem to know how to take advantage of it. Will the investor rush to invest? No. This is the kind of venture which frequently get a response, "Come back later after you focus on a single product and a particular customer."
- Religious missions – There's are business plans which seem focused on someone's particular hobby horse. The writer believes passionately in the innate value of the venture, but without any reference to market data, no contact with customers, no demonstrated understanding of any specific client need. Passion and enthusiasm are great to see when they result from smart analysis of a market space and good realistic ideas. Blind enthusiasm (which looks a lot like those often-encountered twins, naiveté and arrogance) isn't very attractive.
- Idea stage – sometimes one sees a plan in which the founders have an idea which isn't close to market-ready. The founders want investors to fund the creation of a product and then the company will go out there to find out if anyone cares enough to buy it. Some investors just say, "too early," but some get annoyed at this particular combination of naiveté and arrogance.
- Small transactions – Sometimes you see a business model in which the company plans to succeed by somehow finding a way to make a little money on a whole lot of small transactions. The problem which jumps out at a potential investor is that *everyone always* underestimates the cost of selling these small transactions. When you look at a business with big margins on large transactions, there's room for error. When you're considering a bunch of low-margin small transactions, a small error leads to venture death.
- Technically specialized – There are some good products made by good companies which are just, frankly, boring. They'll sell, but they don't seize the imagination of buyers; they don't solve problems which keep CEO's awake at 4 AM. One way to tell if you're looking at one of these is to ask, "Will their sales people ever see a high-level executive in any organization they're selling to?" If the answer is, "Nope, they'll always be passed off to technical specialists," then this company probably won't be an exciting investment prospect.
- Legal / sales document – Sometimes a plan is submitted which was obviously not written by the entrepreneurs. You'll see plans which are legal offering

documents which seem designed to avoid litigation rather than to explain the venture. You'll see plans from business brokers. You'll see plans which are written by for-hire marketing folks, which contain <u>underlining</u> and a lot of *emphasis* and no plan. The authors of these plans and their client entrepreneurs usually make a fundamental mistake: they think that investors need to be sold. In fact, investors are looking for a plan: a good business model, a great team, details of implementation. A naïve sales document doesn't do the trick.

- Implausible CEO – There are a number of incubators which nourish young companies and help get them launched. These incubators often perform a really useful and needed service. But if the organization chart of the venture shows the head of the incubator as the CEO, the founder as the chief technology officer, and practically no other staff, then this won't be a model which investors find compelling. The venture's team is a crucial element of the investment decision and a CEO with another job and a bunch of ventures to look after isn't credible. Moreover, although incubator CEO's are rarely lacking in confidence, they may not have the specialized knowledge required for the particular venture, and this difficulty shows up during due diligence.

The categories listed above aren't meant to discourage you. But you need to know about them and be able to measure your venture against them. Suppose your business falls into one of these categories. It is possible that despite this, you've thought things through and have designed a business which will succeed. However, statistically it's likely that you're working on a plan which fits one of these categories because it's got problems.

How can you avoid these problems or at least have a chance at making them better? I have a few suggestions. The fundamental suggestion is: don't build your venture in your basement, by yourself. Get out and talk with people, especially potential customers. You'll learn what you need to do, what your potential customers care about, who's tried to do what you're doing, and you may meet some potential team members. It's almost certain that this experience will make your business different (and better.)

When it comes to your business plan and business model, if you can answer yes to the following questions, your plan won't fall into one of the standard categories I mentioned earlier.

- Do you have a thoughtful, smart, professional approach to your venture, a real strategy?
- Do you have a team which can implement your plan and beat the competition?
- Do you have something unique that you can protect, good patents or other barriers which keep other people from doing the same thing you're going to do?
- Do you really understand your customers and what they need, and have you designed your venture to meet those needs better than anyone else does?

- Do you have a real plan for how you're going to succeed? Not just some words, but a thoughtful sequence of events?
- Are you planning to build the right kind of company, using your assets to their best advantage?
- Do your financials make reasonable sense?
- Have you put together your presentation and your materials in a way which shows that you know what's needed to succeed?

These are tough questions. But building a business is a very tough job.

Although this paper's title says it's about angel investors, it's really about you. I've tried to help you understand how investors look at plans. You won't change that.

You can annoyed or depressed about the high bar that's set for your venture to jump over. Or you can take up the challenge. The challenge is to build a venture and a plan that's so good that a reader can't put you in one of the pigeon holes for bad plans. Make the reader have to say, "Wow – these folks are good. They're an exception to my usual assumption that their plan isn't worth looking at further. I'm really going to look into this one."

Then the rest is up to you.