

***A Framework For
Sniffing Out
Good Investment
Opportunities***

“No don’t switch it on; just explain the advantages over other insect repellents.”

Basic Business Propositions

The purpose of a business is to find and serve customers profitably... *Peter Drucker*

- Business is about moving money from one pocket to another
- Business game is a delicate balance between fear and greed
- Peoples' actions are determined by their compensation
- Every industry has a rhythm and fundamental knowledge (domain expertise)
- More inexperienced than experienced people in every growing industry - we are destined to repeat mistakes

Money (Fuel) + Expertise (Labour) = Wealth Creation

Hunting the Beast - Looking for Investors

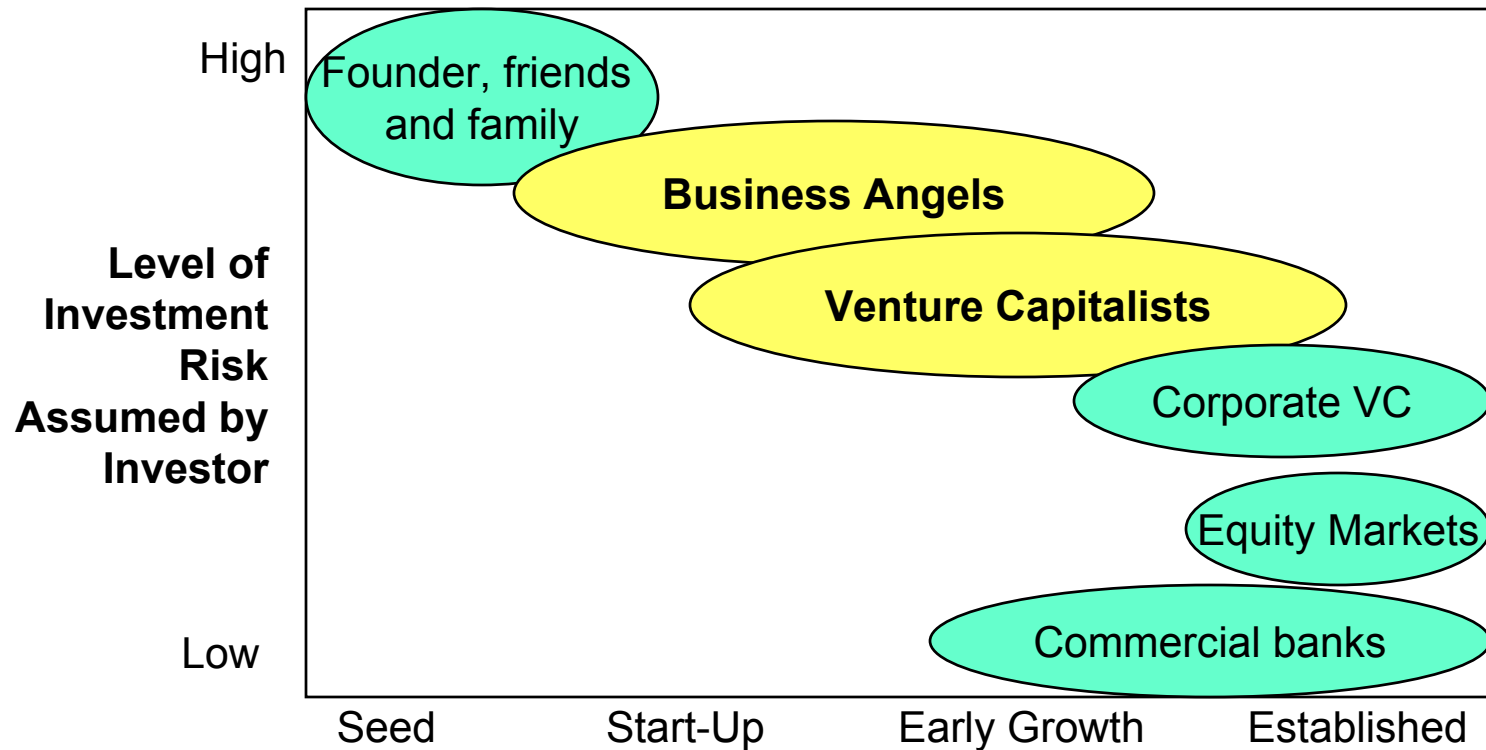


Understand what you're up against

- Finance Landscape
- Angel Investors
- VC Dynamics
- What is a good Investment?

"Where do you think you're going?"

Investment Continuum

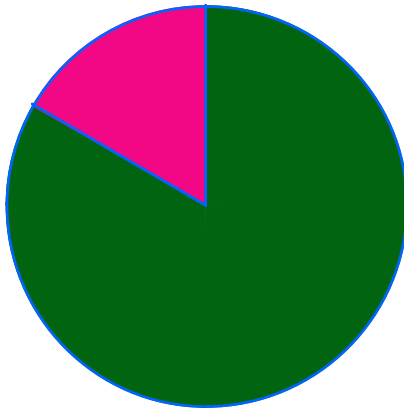


Angel market addresses the \$500K investment gap
between love money and serious money

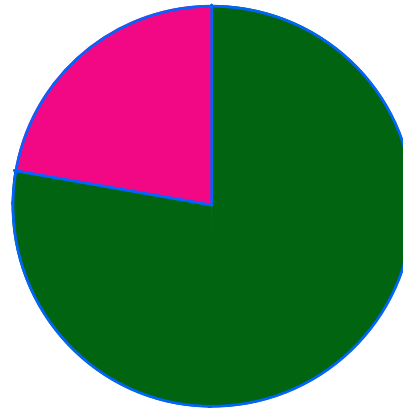
* "Angel Investing"
Osnabrugge & Robinson

Why are Angels Important?

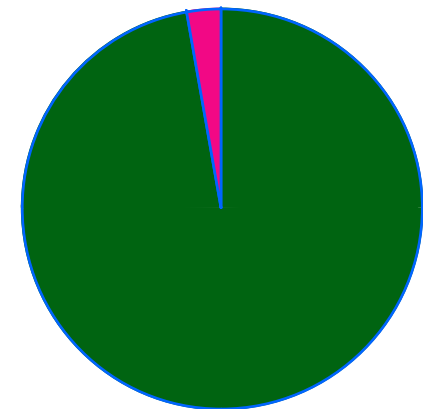
**Comparative Size
of Investment
Portfolios**



**Comparative Size
of Amounts
Invested
Annually**



**Comparative
Number of
Entrepreneurial
Firms Funded**



1999 estimate: US \$50-60 Billion invested by angels

■ **Angels** ■ **VC**

“Angel Investing” Osnabrugge & Robinson

Angel Motivations

- Altruistic - willing to provide:
 - **Advice** - financial and management
 - **Contacts** - broad range to assist in development of venture
 - **Hands-on Involvement** - at basic level, if required
 - **Governance** - Board of Directors / Advisors
 - **Credibility** - sends good signals to customers, partners & investors
- Pragmatic
 - Will hand off involvement to next level of investors ...
 - Therefore will use same criteria as VC to evaluate opportunity
 - **57% of companies with angel investment achieve VC funding**
 - **10% of companies with no angels achieve VC funding**

Dr. Allan Riding, Carleton University research on Ottawa angels

Types of Business Angels



“Millions of years of evolution, and that’s the latest model?!?”

- Professional
 - Doctors, lawyers, accountants
- Micromanagement
 - Very hands on with lots of experience, but may be toxic
- Enthusiast
 - Usually retired, investing is a hobby, little value add
- Corporate
 - Retired senior managers looking to support their investments or create a new senior job for themselves
- Entrepreneurial
 - Most active, successful entrepreneurs looking to diversify portfolio or expand current business

Angel Quirks

Don't

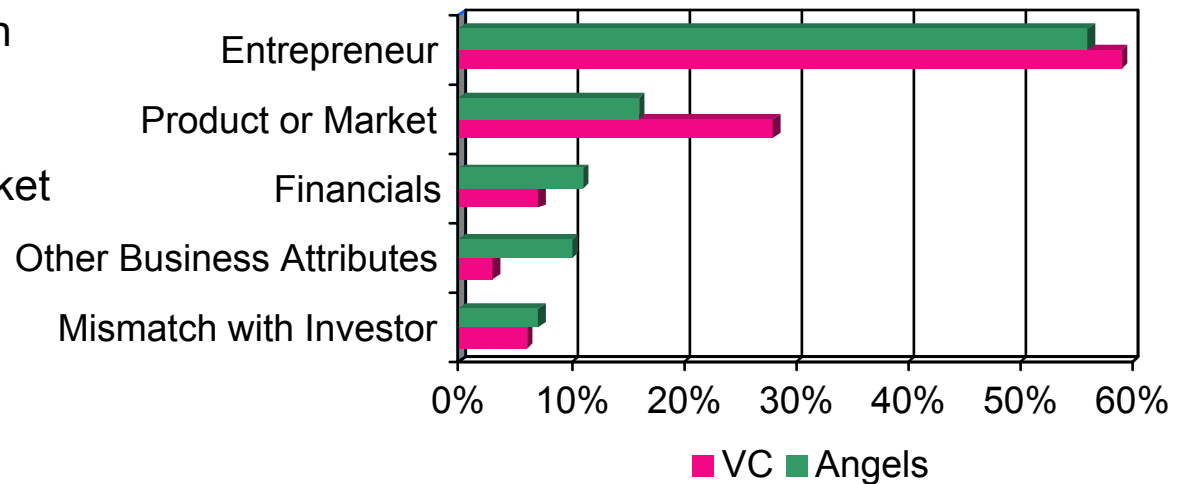
Send a business plan unless asked

Ask for an NDA on the first date

Skimp on the market and competitive research

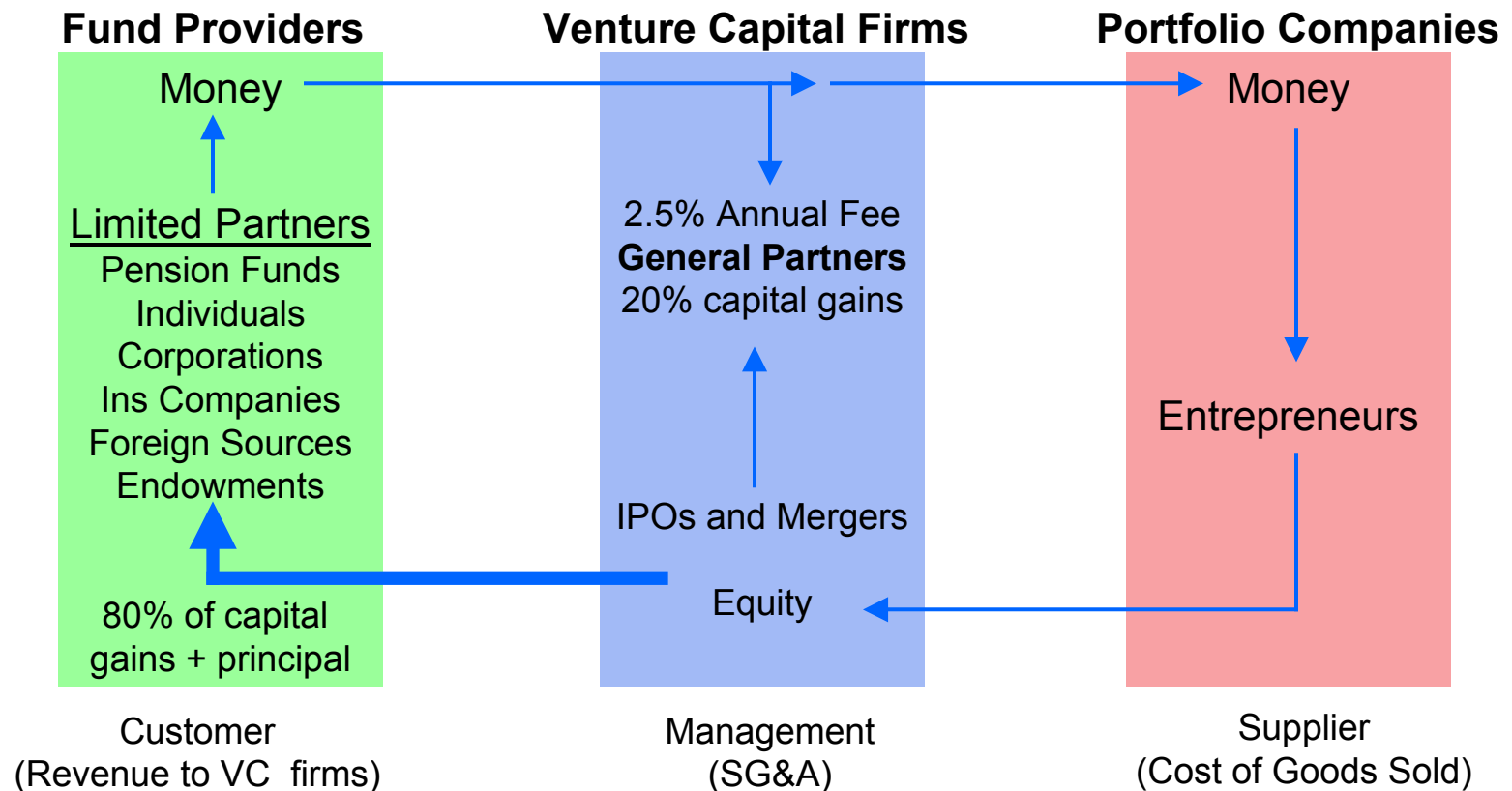
Most Trusted Deal Referrers	Least Trusted Referrers
Friends	Attorneys
Business associates	Accountants
Lead investors in a syndicate	Bankers and gatekeepers

Reasons for Rejecting a Serious Opportunity



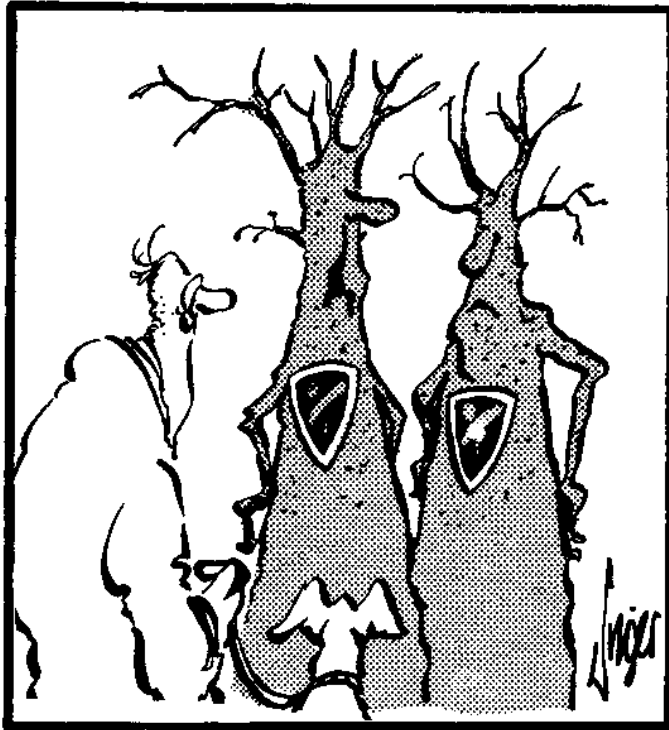
* "Angel Investing" Osnabrugge & Robinson

Venture Capital Drivers



Venture Capital is a money distribution business where entrepreneurs compete for “shelf space” and where only 1 in 100 companies get funded!

VC Quirks



“I’ve been down here before! Watch out for the little guy in the fur coat”

- See lots of projects and will always compare to get best opportunity
- Lots of back room chatting
 - If you are shopping your project, everybody will know about it
- Looking to maximize carried interest
 - Opportunities that can grow big fast
- 90% of VCs are financial people with limited building / operating experience
 - Tendency to flip companies or push them to liquidity too soon
- 10% of VCs have the callouses and scars to help you build a business
 - Can see the bumps in the road before you do and can help avoid a crash

Investing Approaches

Sprinkle and Sprout Approach

- Investors make many smaller investments
- **Bet on management**
- Follow-on investment in successful sprouts
- Fewer than 25% of the “sprinkled seeds” sprout successfully *

Heavy Lifting Approach

- Investors make fewer, larger investments
- **Understand market**
- Active involvement, Advisory Board
- 75% of investees succeed *

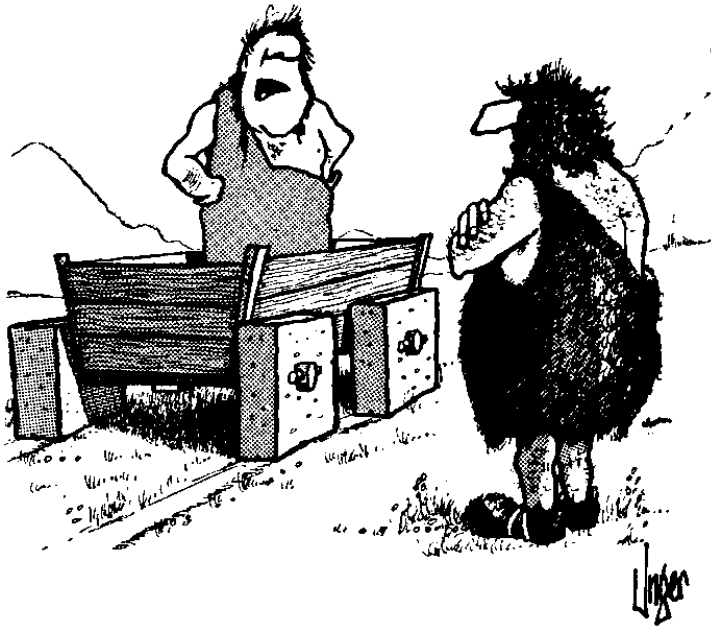
* ONSET Ventures research

Decision Criteria for Investors

	Rank by Angels	Rank by VC
Enthusiasm of entrepreneur	1	1
Trustworthiness of entrepreneur	2	2
Sales potential of product	3	6
Expertise of entrepreneur	4	5
Liked entrepreneur upon meeting	5	7
Growth potential of market	6	3
Quality of product	7	10
Perceived investor financial rewards	8	4
Niche market	9	16
Track record of entrepreneur	10	11

* "Angel Investing" Osnabrugge & Robinson

The Problem - Why Investing Is Difficult



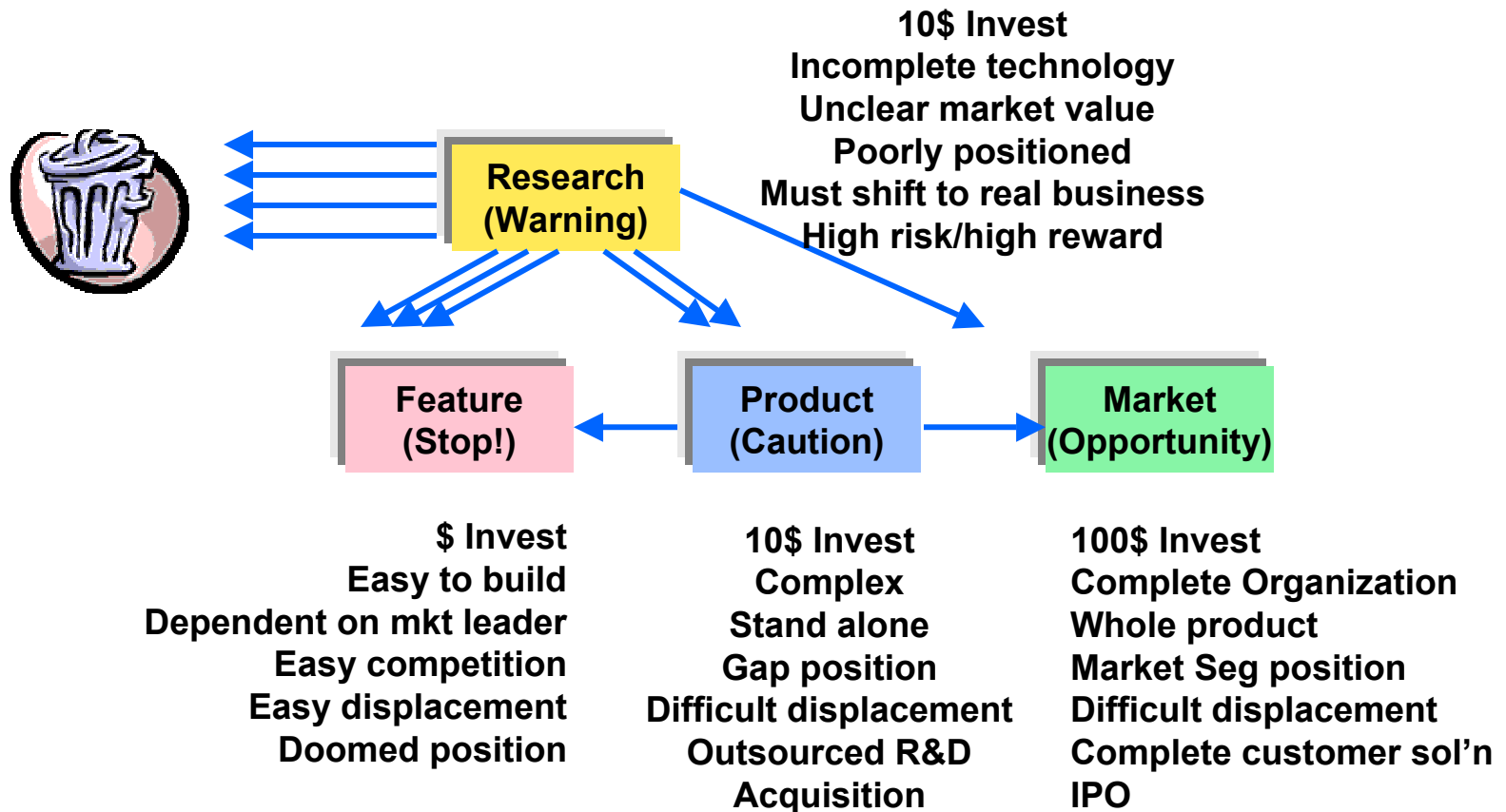
“Ever feel you’re on the verge of an incredible breakthrough?”

- The prospect has:
 - no product,
 - no customers,
 - no revenue,
 - ... just an idea (and it’s off the mark anyway).
- **Remember:** The purpose of a business is to find and serve customers profitably.
 - *Peter Drucker*

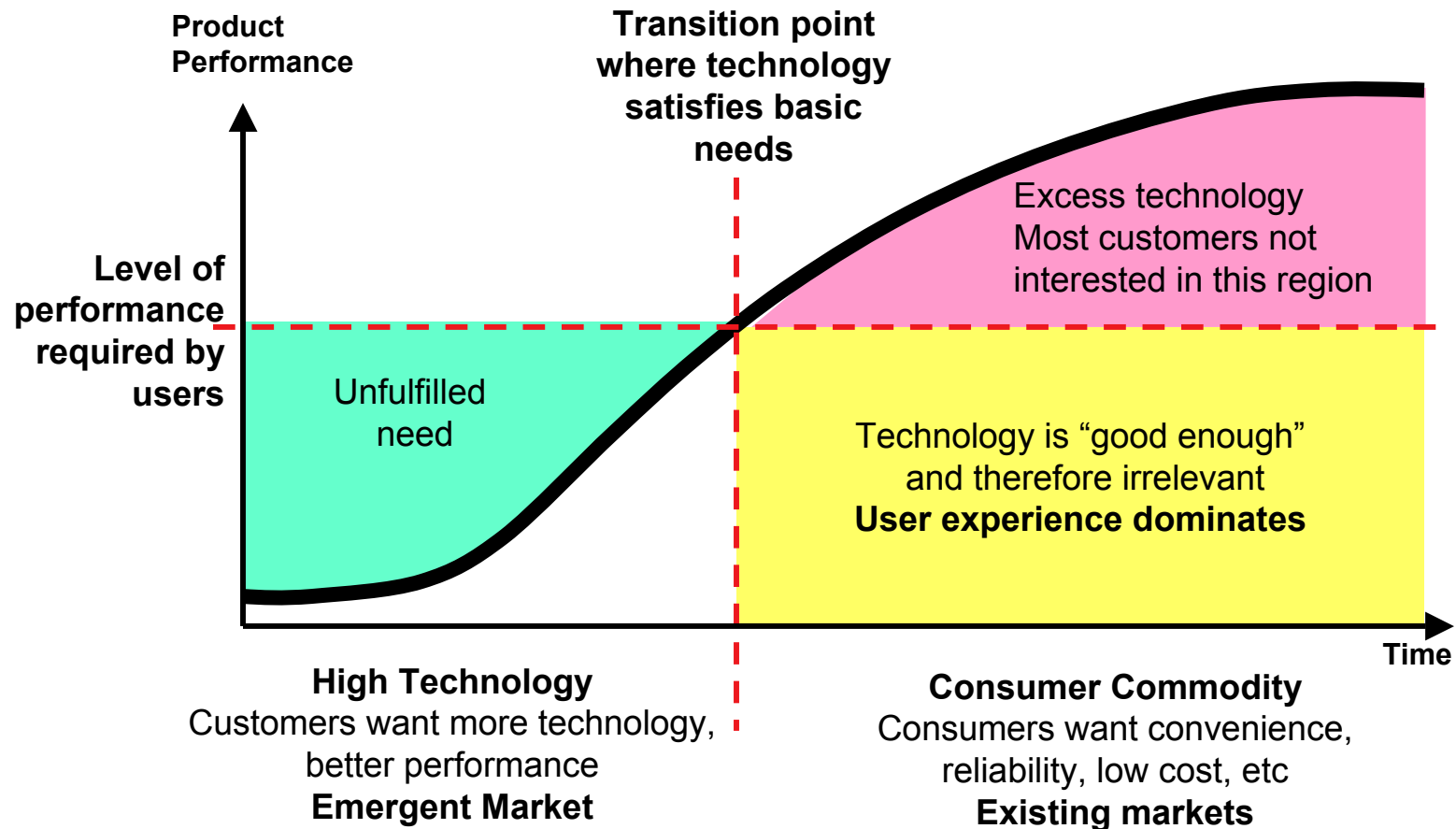
Business Model and Strategy

- Does the story make sense?
 - Who is the customer?
 - What does the customer value?
 - How does the business make money?
- Do the numbers add up?
 - Is there a big enough available market?
 - Do the pieces of the business fit together?
 - Is there sufficient gross margin to allow for mistakes?
- Strategy explains how the company will compete
 - How is this business different from rivals?

What Kind of Business Is It?



Customer Behaviours

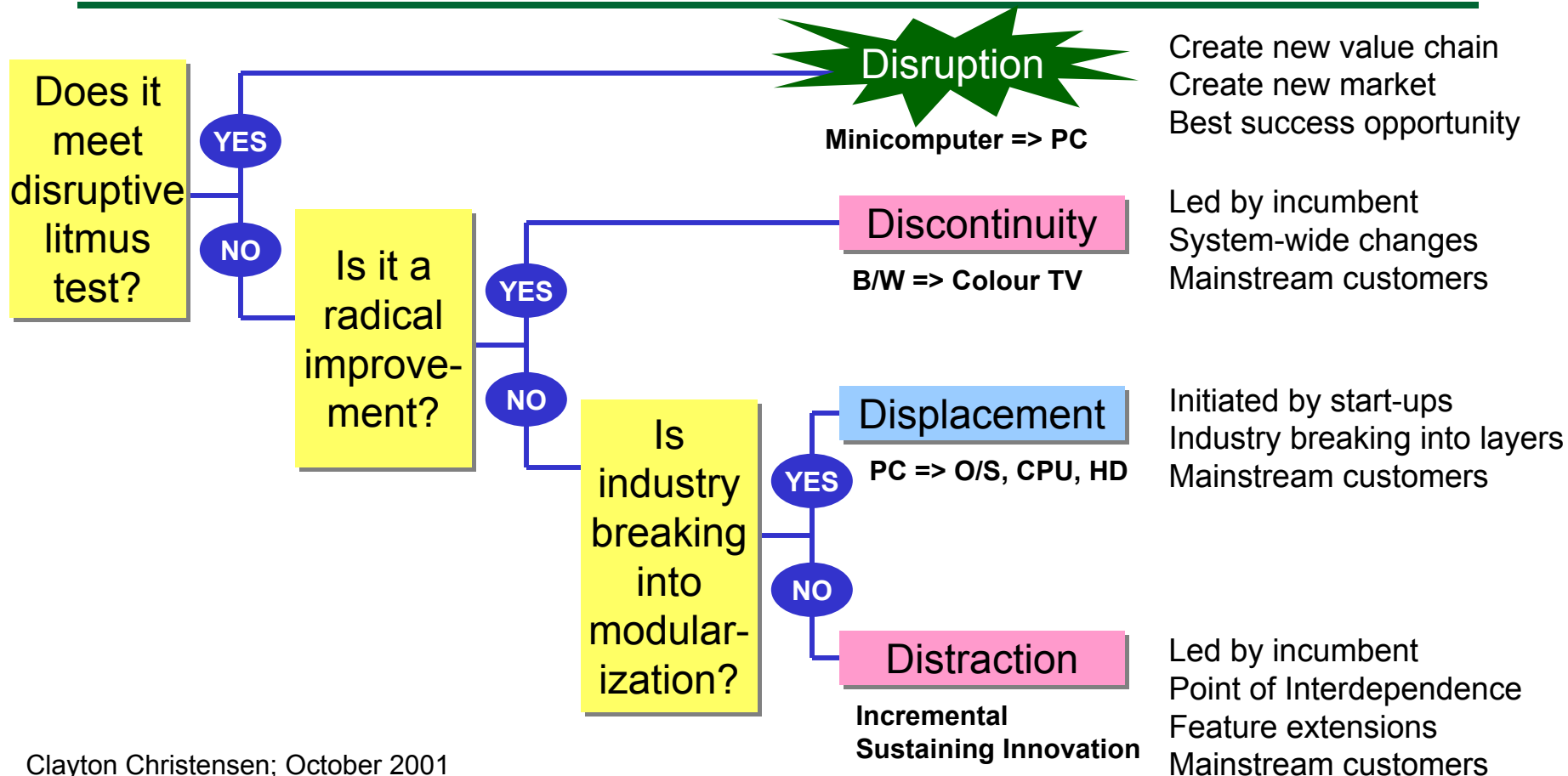


Donald Norman "The Invisible Computer"

Project Characteristics

- Suitable for a “VC financing” path
- Addressing a very large, niche global market (>US\$1B)
- Customers are experiencing “pain” from unsolved problem
- Customers have budgets today to pay for solutions to that problem
- Company is 12-18 months away from commercial product
- Company has a defensible plan to:
 - Reach \$100 million in revenue some day
 - \$20 million in revenue in a 3 to 5 year timeframe
 - Reach breakeven in, say, 24 month timeframe
 - Technology/product is disruptive, not just “evolutionary”
 - Have a sustainable competitive advantage (e.g. patents), not just First Mover Advantage

Industry Change Classification Model



Clayton Christensen; October 2001
“Innovations in the Telecommunications Industry”

Disruptive Litmus Test

LT1: Is there growth opportunity?

Unique application outside of mainstream market

New business model targets less demanding mainstream

Less expert customers can achieve desired outcome

Fit with customers existing patterns of behaviour

LT2: Attract customers from main market?

Good enough for mainstream or still has barriers to improvement?

Physical limitations
Regulatory barriers
Economics of business

Will mainstream value the offering despite limitations relative to incumbent?

LT3: Can incumbent respond?

Option to respond unattractive or impossible?

Will internal processes keep incumbent distracted?

Independent value network developed?

Can technology be co-opted by incumbent?

Clayton Christensen; October 2001
“Innovations in the Telecommunications Industry”

Disruptive Initiators

- Unexpected Event
 - Success, failure, outside event
 - Caused by unexpected customer purchasing behaviour
- Changes in industry or market structure
 - Deregulation in the telecommunications industry
 - Convergence of technologies that were distinctly separate
- New Knowledge
 - Long lead time between new knowledge and practical application
 - Sudden turbulence, tremendous start-up activity, then shakeout

Displacement Initiators

- Incongruity
 - Difference between perceived and actual customer values and expectations
- Innovation based on process need
 - Self contained process that has a weak or missing link
 - Clear definition of the objective leads to specs for solution
- Demographics
 - Size, age structure, employment, education, income
 - Unambiguous, clear lead times and predicable consequences
- Changes in perception, mood and meaning
 - Underlying facts are at odds with excepted long held view

Management

Criteria	Low (Bad)	High (Good)
Corporate History	Long (not getting traction, lacking necessary skills)	Short (no baggage or legacy businesses)
Management	Gaping holes in team, 1st gen entrepreneurs, immature and unproven skills	Proven track record, well rounded team (architect, tech implementers, business development)
Offering Superiority	<2 times value improvement	4-10 times value improvement
Development Milestones	Ill defined and hard to pin down	Well defined, verifiable and trackable, 12-18 months to commercial product, break even plan, \$20M revenue 3-5 yrs

Market

Criteria	Low (Bad)	High (Good)
Market Size	Large (above the radar screen)	Small & early stage (emergent)
Mkt Growth Opportunity	Low & short lived (fad)	High & long term, >\$1B, global niche
Market Type	Not well established, needs new budget allocations	Well established need with existing budgets, clear customer pain
Potential Customers	Few, under funded, soft sector	Many, well funded, good business fundamentals

Business

Criteria	Low (Bad)	High (Good)
Channels to Market	Channel business peripherally correlated to prospects offering	High correlation between prospect offering and channel business
Competitors	Many with strong & great products	Few, complacent, under capitalized, weak differentiation
Barriers to Entry	Low, channel related (exclusivity)	High, intellectual property, trademarks, brand related
Exits	Few, soft demand	Numerous, high demand

High Tech Business Failure Modes

Failure Mode #3

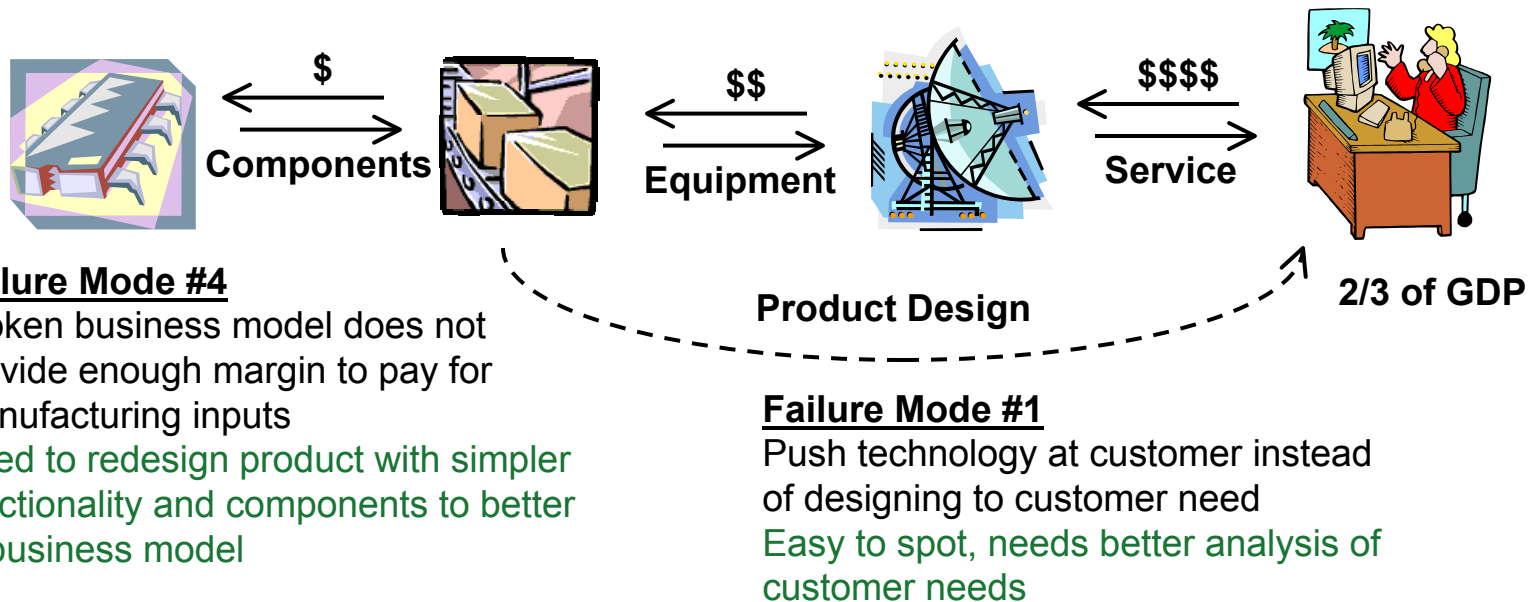
Major part of product is support and financing - difficult to sell against majors

Requires correct market positioning to avoid direct competition

Failure Mode #2

Manufacturer does not understand service provider business model

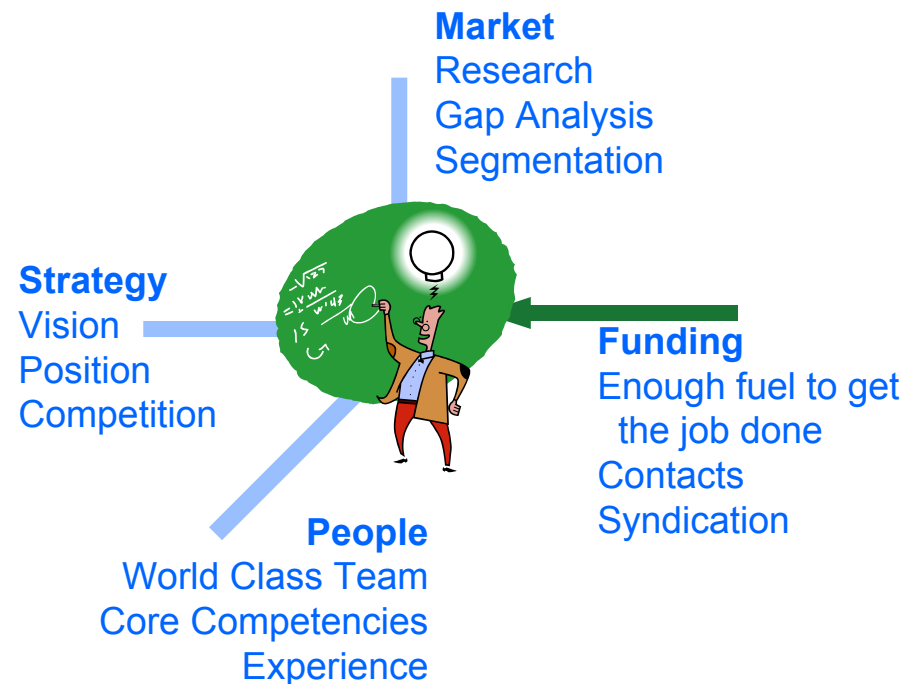
Very common but subtle
Needs extensive analysis



Building a Survivable Business

Usual Pitfalls

- High Tech companies start with technology focus
- Market understanding is weak or faulty
- Business model may be broken
- Competitive position is not well understood
- Team may be missing key people or have weak senior members
- May get under funded for the strategy



Improving your Chances of Winning

Technology Strategy at Entry	New Technology	Almost no success by start-up companies	Moderate success by start-up companies and good returns
	Proven Technology	Limited success by Start-up companies	Best success by start-up companies and high returns
		Established Market	Emerging Market
Market Strategy at Entry			

“The Innovator’s Dilemma” - Clayton Christensen

What's Your Company Worth?

If you have this	Add to Company's value
Sound idea	\$1 million
Prototype	\$1 million
Quality management team	\$1 million to \$2 million
Quality board	\$1 million
Product rollout or sales	\$1 million
Total potential value:	\$1 million to \$6 million

- So now you know how angels are likely to value the deal. Price your company accordingly.
- Of course, you can always ask for more. The risk? You won't be taken seriously.

Some Final Soul Searching



“Now whatever happens, hang on to those sandwiches!”

- If the investors ask, will you change the direction for the product or the company?
- If the investors ask, will you change the management?
- Will you accept dilution of ownership which may be greater than 50%?
- **Will you still stay with the company even if all of the above occurs?**