Writing For The Business Plan Audience

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Writing a business plan is a tedious and involved process which, if done right, should force you to focus on the strengths and weaknesses of your business. A well-written business plan will give you a blueprint for operating and growing your business. Unfortunately, when the goal of writing a business plan is to get money to carry out the business plan, too often the audience for the business plan -- a prospective investor -- is forgotten.

There are two main reasons for this. First, the involved process of writing a business plan naturally focuses the author on the business and its needs. Second, most business plan authors do not have access to the prospective investor when they are writing the plan. Generally, the opinion from the prospective investor comes well after the plan has been written and while capital is being sought.

Investors Have Problems Too

Meanwhile, the capital market is becoming increasingly competitive. Venture funds are doubling annually. The venture funds are getting bigger and, because of the relatively high cost of doing due diligence and reviewing potential investments, they are concentrating on larger instead of smaller deals. The fields being invested in are also growing narrower. In 1999, for instance, Internet specific investments were most of the investments made by venture funds. As the economy changes and perceived opportunities change, this concentration on Internet specific investments will change as well.

Management - The Investor's Focus

From the prospective investor's perspective, the investment is made in management; not just specifically the business. The prospective investor is looking for the experience the managers have in the market they are or intend to sell to. The prospective investor is also looking to see if the management team has the skill necessary to carry out the plan. If the management team does not have all of the skills needed to carry out the plan, the plan should state what specific skills the management team has, what specific additional skills are needed and identify how the additional specific skills needed will be added to the management team. If management has identified candidates, those candidates should be revealed. If candidates have not been identified, then the business plan should discuss what skills management intends to look for in prospective candidates.

The business plan and the management team presenting it should be prepared to have real answers to questions about competition, finances, the market, the structure of the management team including the Board of Directors and the structure of the deal. Management should be prepared to have outsiders join the Board of Directors. Those outsiders may or may not be people directly associated with the potential investors. They may be people who have a proven track record and credibility with potential investors, making it more likely that potential investors will take the deal seriously.

The business plan which dwells on discussions of technology and detailed comparisons of current technology to your proposed technology instead of dwelling on the market and showing that management understands it and how to sell to it will, generally, undercut the confidence a potential investor has in the plan. It tells the potential investor technology is more important to the business than the market; an approach investors know very rarely works. In fact, a business plan which dwells on technology development as opposed to the market will likely only interest an investor who knows the market extremely well -- i.e., a potential or actual competitor. Unless the business plan is handed out under a nondisclosure agreement and the purpose of the business plan is to get a potential or actual competitor to buy your company, this is not likely to be a fruitful way to proceed.

Investors Want High Returns Because They Need Them

Most important, management must understand and accept that the goal of a prospective investor is to make a high return on the investment. Usually, the prospective investor is looking for a higher return than management would generally regard as acceptable. There are two reasons investors look for a high return is simple.

First from the perspective of any prospective investor; all deals are risky. The question is how risky is this deal compared to other deals on the table. Management has to understand that generally, about 25 percent of the deals funded by venture capital firms end with an initial public offering. About one-third of the deals funded by venture capital firms end with the company being bought by another company. About 5 percent of the deals funded by venture capital firms end with management buying back the investment made by the venture capital firm. Finally, about one-third of the deals funded by venture capital firms end with the venture capital firm losing its investment. When management understands that one-third of the time, on average, the investor will lose the investment, management can understand why high returns are important.

Second, management needs to understand that the venture capital fund has customers too. There are several sources of venture capital money. A large source is retirement and other investment funds. They often put 5% - 10% of their total portfolio into venture funds as the "high risk" portion of their investment strategy. They do that because they are looking for returns which are higher than the returns they get in the stock market; generally something in the 15% - 25% range. The venture capital funds attract this money by presenting investment plans to those funds which, as you might guess, talk about planned returns over what the market is providing.

A way to get a perspective on the comparative risk faced by an "angel" investor or a venture capital firm is to look at default rates on credit cards and bank loans. Default rates on credit card accounts and bank loans run in single digit percentages. A 5 percent default rate on credit card accounts and bank loans is high. Credit cards routinely charge interest rates in the 15 percent to 21 percent range. Bank loans start at prime and go higher. Mortgage loans, which generally carry interest rates in the 6 to 9 percent range, have default rates which average less than 1 percent. In addition to relatively minuscule default rates when compared to the one-third of venture capital investments which become losers, bank loans and mortgages are usually

secured loans. This means the lender can get the borrower's assets and, often, can get the assets of one or more guarantors.

When you compare paying a guaranteed interest rate of 10 to 12 percent, pledging the business assets, pledging personal assets and providing guarantees for a bank loan, the fact that an investor is looking for 40 percent annual returns over time for an unsecured investment is not as big a difference as it looks. Add that one-third of those investments will become losers and management should be able to readily understand why investors look for high yields.

When describing the market the company intends to sell into to the potential investor, be sure that when reading your plan or talking with management, the investor can understand what is driving the market. Why do people buy the product or service the company provides or intends to provide? If you are already in the market, why do people buy the company's product instead of someone else? What is it that your company has or provides which allows it to fend off the competition?

Sales Projections From The Investor's View

If the product or service the company will provide is new or is an improvement on what is in the market now, what kind of evidence is there that the customers are ready to switch from what they are doing or using to adopt this product or service? How much teaching will be required to have the market understand that the new product or service offered is better than what is currently on the market? Do people have to do anything different from what they are currently doing to use the product? The more difference there is between what people are doing now and what people have to do to use the product, the longer the sales cycle will be.

All of the steps in the sales cycle have to be considered to make a rational sales projection. Business plans always describe a direct sales operation either internal to the Company or through some distributorship basis. Each step in the selling cycle must be accounted for. Consider what the average sales call will require in terms of money, time and effort; how many sales calls need to be made in what locations; what the success rate will be and what the average resulting sale will be. It is not enough to simply say how much product will be sold. The plan must show that management understands what effort is necessary to actually achieve those sales.

Dealing With Competition & Market Entry

When dealing with the subject of competition, most business plans discuss who the competitors are, what they offer and why what the company plans to offer is better. That is not enough. The barriers to entering the market need to be identified specifically instead of simply saying there are barriers to entering the market. You need to specifically identify which barriers apply to your plan and how the company will deal with them.

When discussing the competition, show that management understands that what is being done now (especially if it is different from what customers will need to do with the company's technology) is actually competition to the business. If the product is such that it will require

people to change the way they do something now, the marketing program must teach the market about the comparative benefits of changing the way they do things using the product. This will lengthen the selling cycle and needs to be accounted for in the marketing plan.

Where the plan calls for the creation and use of new technology, it needs to describe how the company will defend its position against both the development efforts of old technology which is being substituted. It also needs to show how the company will maintain the uniqueness of its new technology against potential future competitors. What gives the company the uniqueness to stay in the market against these old and new competitors?

You Really Want One Financing Round?

Consider the deal itself. First; how much money is needed to get where the plan says the company wants to go and what will that money be used for? The plan should show the actual uses of the money put in and how the company will arrive at a given point of development of either the technology or the business itself with that money.

Second, accommodate for a second round of financing if it is needed. Investors understand that it is extremely unlikely any business plan will actually come in for less than what is projected and it is probable that a second or even a third round of financing will be necessary to actually achieve the plan goal.

Think about this investment cycle from the investor's perspective. The investor is interested in reducing risk while using the investment to arrive at a point in the development of the company where something of value has been created and the business is at a point where it is logical to make a decision about whether the technology and the market have developed such that continued investment is worthwhile.

This is an important perspective to understand. The passage of time alone will change the risk factors associated with any business plan. Even if all the development inside the company proceeds according to plan and on budget, what is happening in the market outside the company may not be happening in the same way or on the same schedule as assumed in the plan.

The typical investor needs to be able to take second and third looks at how the risk factors are changing. It is important that these second and third looks happen when the technology or business development of the company is where something of value has been created. This allows both management and the investor to review the situation logically at those steps and decide whether aspects of the plan need to be revised.

A plan which assumes there will be one round of financing to complete technology development and bring the completed product to market on a national or international basis is a high-risk plan. Once the capital has been committed and a course of action commenced, the potential for waste in the development cycle is very high in this scenario.

Similarly, a plan which assumes several rounds of financing without connecting those rounds of financing to logical choice points in the technology or market development means a high potential for future investment dilution and waste. This is because the next round of financing will be needed when it will not be apparent how the prior investment created value. Not being able to see how the prior investment created value means it is more difficult to see how a new investment will create more value.

Forget The Investment Details

One area of the business plan where management should not spend much effort is the question of the structure of the company and, except either a general outline or several potential scenarios, the exact form of the investment. Whether the investor will want seats on the Board of Directors, preferred stock, convertible stock, warrants or other particular forms for the investment are all choices the investor will want to make. Spending much space and energy in the plan on these issues only turns potential investors off if the choice of form of investment that is proposed (and seem to insist on by having a long description in the plan) is not the form of investment the potential investor is looking for.

Value=Beauty...The Beholder's Eye

The $64 million (or maybe more) question is valuation. This is where the most detailed and intensive negotiation between a potential investor and the business plan sponsor happens. In most situations, discussions about valuation center on using comparables; i.e., transactions believed to be like the transaction proposed. Of course, whether a transaction is really "like" the proposed transaction and whether the new business proposed by the business plan is really "like" the business used as a comparable is, finally, in the eye of the beholder.

There are various professional methods used to value companies and valuation formulas vary from industry to industry. The bottom line on valuation discussions is that they are very personal. Management believes that the idea, intellectual property, industry knowledge, technology development and market sense they bring to the table has a high value. The potential investor believes that, largely, the value of the idea, intellectual property, industry knowledge, technology development and market sense management has cannot and will not come true without the cash. The potential investor is also looking at the ultimate return received. The lower the pre-cash valuation of the company, the higher the potential return to the investor.

There are as many opinions on how to negotiate valuation as there are people giving them. One approach is to look at how much money is needed now and how much money will be needed in a second or third round. Project what the company will look like when the second or third round of financing is needed and what the value of the company will be at that stage. Try to consider what will happen if the first round does not go as well as projected. What will happen to the company's value when the second round is needed? The result of those considerations creates a starting point.

If the second or third investment round will partially or fully come from investors other than the original investor, the original investor is looking at the fact that there will be some kind of discount on the investment when those second and third rounds happen. The potential first-round investor will want a lower pre-cash valuation to accommodate the discount they will be taking in future rounds.

It is an open question as to whether a plan should have any valuation numbers or rates of returns in it at all. This is another area where you will get as many opinions as you have people giving them. Some argue that unless valuations and rate of returns are shown, it is difficult to interest potential investors in the plan. Others argue that investors really make their decision on the plan and the perceived quality of the management team and investors are sophisticated enough to be able to negotiate valuations and return rates once they are interested in the business.

One thing is certain. If there are valuations and potential rates of returns in the plan, they should be accompanied by appropriate disclosure language. Management should be prepared to negotiate both of them.

Exit Stage What?

An area business plans tend not to deal well with is the exit strategy. This is because management's perspective is that they are building a business which will provide income and long-term value.

On the other hand, the potential investor is looking at return and risk. The longer the investment has to be in the company and the less clear the plan on how the investor will reap the return, the higher the inherent risk. Management has to consider who will buy the company or the investor's investment, when that will happen and what the potential price for that purchase will be.

Too frequently management deals with this by saying the company will have an initial public offering. A public offering is generally not what ultimately happens. Public offerings are very expensive and rely heavily on an unpredictable stock market. Only about 25 percent of investments made by venture capital funds (and even less of those made by "angel" investors) end in initial public offerings. In one-third of the cases the company is bought by another company; generally a competitor in the industry. Another 5 percent of the investments are bought back by management. Understanding which of these alternatives is the most likely exit strategy for your business plan is important.

Qualifying The Prospect

The business plan should treat the potential investor as the prospect. Management is selling the potential investor a part of the company. As with any prospect, the first thing that has to be done is to qualify it. Make sure you are talking to and writing for the right prospect.

Practically all venture capital firms and angel investors limit the investments they make by one or more of (1) the stage of the investment; (2) the amount of the investment; (3) the industry of the investment; (4) the projected return on investment and (5), sometimes, the geographic location of either the company or the market.

Even if the target venture capital firm or angel investor has an investment profile which matches what the business plan is looking for, management should be looking at whether the potential investor has the contacts to help it grow the business. Management should be asking whether the potential investor can get to the next financing round in terms of knowing the people or institutions who are the likely candidates for that next round. The company also needs to know whether the potential investor can help with the resources needed for the operation of the business plan like industry contacts, leads on the potential customer base and, given the tight labor market, leads on pools of labor resources needed to carry out the plan. Remember, the company is making a deal with someone who will be its partner for the next three to seven years.

The Wings of Angels

An increasing number of investments are being made by what are known as "angel" investors. Until relatively recently, this area of the market was very informal and unstructured. It remains a very informal area even today. Three things have changed to make this a more important investment avenue.

First, venture funds are getting larger and the overhead of the due diligence and management on an investment is such that the funds are looking for larger deals. This creates an underserved market for smaller deals, especially those under $1 Million.

Second, the aging of the baby boom generation, corporate downsizing, 401k plans and IRA plans have all combined to create a pool of individuals who find themselves with time, money and a skill set that frequently includes senior management and investment skills. And, they are frequently under retirement age. Another phenomenon is that the long-term bull market and growing economy have created a relatively large number of wealthy private individuals who got that way from growing their own businesses and are looking for ways to help others do it.

Third, there are now several organizations of angel investors who are available to refer to their members.

Angel investors are, generally, what are known as accredited investors in securities parlance. While a detailed description of accredited investors is beyond the scope of this paper, it will be important to make sure that if dealing with an angel investor, the investor be an accredited investor. A competent and experienced business lawyer can help with getting that certification.

Angel investors make what are known as seed or start-up investments. Seed investments are where all you have is a concept for a company with no actual product or actual business. Seed investments generally run in the area of $25,000 to $500,000 depending on the project and its potential scope. Start-up investments are where you have more than a concept for a product.

Generally, the product is at least partially created and some initial marketing may have been done. Start-up investments generally run in the range of $500,000 to $3 million. These scopes are only general indications. The amount of either seed or start-up investment which is necessary for a particular business will depend on the specifics of the business.

Angel investors are more willing to invest in plan proponents or entrepreneurs who have no prior experience in running a business. The entrepreneurs may be people who have prior experience in the industry but not at a management level. Angel investors also tend to be more informal about their due diligence in an investment and tend to be more personally involved in the investment itself at a managerial level. Venture capital firms will usually be active at a financial level in the business.

Even in the angel investor community, there are different types of investors. One group is generally called "Guardian Angels" which is used to describe accredited investors who have good management skills and knowledge of the industry. Frequently, these investors have built companies themselves. As a result, the company can expect these investors will bring more to the deal in terms of assistance, advice and contacts than simply the money.

The other group of angel investors are financial investors. Generally, they only bring money to the deal.

If your business plan proposes a start-up or seed investment and targets angel investors, it is important to know whether a Guardian Angel or a financial angel is needed. If the company needs more than money, it is likely that a Guardian Angel will fit the bill. If a Guardian Angel is needed, the company needs to do some due diligence by getting the resumes of the potential investors and making sure that the other elements needed for success are actually there. Don't forget that especially in the Guardian Angel arena, "chemistry" and "fit" and sharing the same long term vision are important elements; it's not just money the company is buying.

Angel investors deal in start-up and seed investments. They are very concerned that the plan and strategy of the entire operation are such that the business will be fundable by a venture capital firm on the second round. Angel investors understand that there will be a round beyond them. If it is not likely that a second round will happen, they effectively have no exit strategy. Therefore, the thinking behind the plan presented to them is generally more important to them than the actual plan itself. They need to be convinced that with the money and other investments they make in the company it can put itself in a position where a venture capital firm is likely to be interested in taking the company to the next level.

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